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POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY

UNITED STATES OF AMERICA
Before The
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

Postal Rate and Fee Changes) Docket No. R2000-1

REPLY BRIEF

OF

THE OFFICE OF THE CONSUMER ADVOCATE

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The Office of the Consumer Advocate ("OCA"), pursuant to Rule 34 of the Rules of Practice and Procedure of the Postal Rate Commission ("Commission"), 39 C.F.R. §3001.34, and pursuant to Ruling No. R2000-1/71, hereby submits its Reply Brief on the Request of the Postal Service for a Recommended Decision on Rates and Fees for postal services.

SCOPE OF THE OCA REPLY BRIEF

Thirty-eight initial briefs were filed by the Postal Service and the participants in this proceeding. Under the time constraints for a reply brief in a postal rate case, it is not possible to reply to or comment on each argument presented. In the brief that follows, the OCA will discuss several key issues in this case. To the extent that the OCA does not respond to an individual participant's argument related to an issue discussed in the OCA Initial Brief, however, that does not indicate that the OCA's views have changed. The OCA urges the Commission to issue its recommended decision consistent with the evidence and arguments presented by the OCA in this case.

EXECUTIVE SUMMARY

The excessive level of the Postal Service's contingency request has been challenged by the OCA and by 27 intervenors representing every class and category of mail user. The importance of a careful review of the Postal Service's contingency request cannot be overstated. As the OCA has shown in its evidence and argument, the credible and substantial evidence needed to change the existing one percent contingency to the 2.5 percent requested by the Postal Service simply is not present. On this record, the Commission has no choice but to recommend a smaller contingency. The Commission has the authority to do so and must exercise it in this case. The OCA urges the Commission to recommend the existing one percent contingency provision.

The Commission should not be stampeded into reducing the volume variability of mail processing operations. The Postal Service has not demonstrated unambiguously that mail processing costs must be substantially below 100 percent. Many of the flaws noted by the Commission in Docket No. R97-1 and the OCA have carried over to the current study, including the specification of the model, the data scrubs performed, and the continuing short-run analysis. A voluminous record in this proceeding does not translate into one that provides the necessary substantial, credible evidence to support a change in the existing methodology. The Commission should continue to apply 100 percent volume variability to the affected mail processing cost pools. With respect to city carrier street time, the Commission should accept the Postal Service's ES-based percentages, but should continue to employ LTV-based elasticities to attribute elemental load time. Finally, the Commission should continue to attribute coverage-related load time by means of single subclass stop ratios.

The Commission should carefully consider the minimum cost coverage to be applied to any service. By reducing cost coverage to near-zero (approaching 100 percent of attributable costs), the Commission runs the risk of services actually falling short of covering their costs, the primary statutory mandate of the Postal Reorganization Act. The OCA recommends that the minimum cost coverage for any service be 105 percent.

The OCA urges that the 33-cent First-Class basic rate be retained. The declining costs of handling letter mail should be recognized, and the trend toward increasing the institutional cost burden of First-Class letter mail should be reversed. The answer lies in holding the line on the basic rate for the benefit of all First-Class mailers, not in granting larger discounts for large mailers only. The cost-savings benefits of Courtesy Envelope Mail should be recognized by a discount for single-piece mailers. The Postal Service should overcome its obduracy. If the Postal Service wants First-Class Mail to be valuable and relevant to consumers, it must give consumers choice and value.

The Priority Mail flat rate should be set at the new one-pound rate. The Postal Service has introduced a one-pound rate in recognition that the jump in the proposed two-pound rate is too high. Yet, for the flat rate envelope, frequently used by consumers for very low weight items, the Postal Service proposes to use the higher two-pound rate. Imposing a 20 percent cost increase for flat rate envelopes is a lose-

lose result. It will penalize consumers who want the convenience of the envelope provided and it will cause a reduction in the use of this uniform, machinable piece.

The Postal Service's attempt to change the additional ounce methodology must be rejected. The "as-filed" method correctly reflects the long-term trend toward increasing additional ounces. The belated effort to change the methodology is a thinly veiled effort to offset the correction the Postal Service had to make to reflect overpayment of postage that had been erroneously omitted from its filing. The Postal Service's defense of the anachronistic nonstandard surcharge for low-aspect ratio mail also is unconvincing. The data does not support the surcharge for this limited segment of mailpieces.

Attacks by intervenors on the OCA's innovative single-piece First-Class Mail rate stability concept are unwarranted. A technique for holding the stamp rate level for a longer period of time is a win-win situation for consumers and for the Postal Service. The intervenors fears are baseless; the concept promoted by the OCA would not shift costs, limit litigation, or otherwise unfairly affect other mailers.

Finally, the OCA cost model provides an accurate replication of the Postal Service's cost model and improves upon that model by eliminating the distorting impact of the Postal Service's rounding at each step. The Postal Service should adopt the OCA's model, and the Commission should rely upon it in reaching its recommended decision.

ARGUMENT

I. THE COMMISSION SHOULD ADOPT THE OCA'S CONTINGENCY PROPOSAL

The Postal Service's excessive contingency request has unleashed widespread and severe criticism by almost all of the active participants to this proceeding.[1] The $1 billion increase—to a 2.5 percent contingency—is not supported by substantial evidence, has not been adequately explained, and would be counter-productive to postal and mailer interests. The OCA, on the other hand, has presented convincing evidence that the most prudent course of action is to maintain the contingency at its current one percent level. The OCA's position should be adopted by the Commission.

A. The Postal Service's Attempts To Minimize the Magnitude of the Increase Are Unpersuasive

In its brief, the Postal Service characterizes its proposal for a $1 billion addition to the contingency[2] as a "slightly higher level of protection" and a "simple mathematical

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[1] The Postal Service's contingency request is actively opposed by the OCA, the Direct Marketing Association, Inc., ADVO, Inc., the Alliance of Independent Store Owners and Professionals, the Alliance of Nonprofit Mailers, Amazon.com, Inc., American Business Media, American Library Association, the Association for Postal Commerce, the Association of Priority Mail Users, Inc., the Coalition of Religious Press Associations, Dow Jones & Company, Inc., the Florida Gift Fruit Growers Association, the Magazine Publishers of America, the Major Mailers Association, the McGraw-Hill Companies, Inc., the Parcel Shippers Association, Time Warner, Inc., the Greeting Card Association, Hallmark Cards, Inc., the American Bankers Association, the National Association of Presort Mailers, the American Association of Publishers, Val-Pak Direct Marketing Systems, Inc., Val-Pak Dealers' Association, Inc., Carol Wright Promotions, Inc., and the Classroom Publishers Association.

[2] The Postal Service's request for a $1.68 billion contingency provision (Tayman Exh. USPS-9A) versus the OCA proposed contingency of $676 million (Tr. 41/18303).

phenomenon."[3] Unfortunately for the Service this public relations ploy simply does not work. As the OCA pointed out in its brief (at 41) the Postal Service's contingency proposal in this proceeding comprises an unprecedented 60 percent of the requested increase in revenues. Furthermore, the 2.5 percent proposal has another dubious distinction, *i.e.*, in every rate case from Docket No. R76-1 through R97-1, the Postal Service has proposed a contingency that either maintained the level from the previous case[4] or proposed a *reduction* in the level of the contingency.[5] The sole exception to this pattern is found in Docket No. R84-1 when the Postal Service proposed a more modest 17 percent increase in the proposed contingency (from 3% to 3.5%). That is a far cry from the Service's proposal to increase the contingency 150 percent in this proceeding.

For these reasons, the Postal Service's contingency proposal must be scrutinized with greater care than past proposals. The Postal Service's arch suggestion that a cynic might question whether a double standard is being urged (USPS Brief at II-4) reveals a misconception about the Postal Service's burden of persuasion in the instant case. Where the Postal Service seeks a substantial increase in a cost component, it is indeed subject to the requirement that the change be supported by

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[3] USPS Brief at II-4, -2. The Postal Service's description of the proportion of the contingency as a fallout of a modest operating deficiency and growing budget adds further weight to the conclusion that the Service selected 2.5 percent ($1.68 billion) as a plug figure. *See* OCA Brief at 67-73.

[4] In Docket No. R77-1, the Postal Service proposed the same contingency as it had proposed in Docket No. R76-1; likewise in Docket Nos. R84-1, R87-1, and R90-1, the proposed contingencies were the same.

[5] The Postal Service's Docket No. R80-1 contingency proposal was a reduction from its Docket No. R77-1 proposal, and the Service's Docket No. R94-1 proposal was a reduction from its Docket No. R90-1 proposal.

credible and substantial evidence, not just subjective management selection. OCA Brief at 12-14. Earlier proposals to reduce or maintain then-current contingency levels do not require the same degree of support or examination.

Citing the Commission's opinion in Docket No. R94-1, which approved the Postal Service's requested reduction in the contingency, the Postal Service attempts to convince the Commission that the lesser showing made in that case, as compared with the greater showing required in R2000-1, is unfair. Ironically, in its brief, the Postal Service has cited Commission statements indicating that the Postal Service does bear a heavier evidentiary burden in a case such as this, in sharp contrast with the circumstances extant in Docket No. R94-1. The Service quotes from important passages in the Docket No. R94-1 opinion that describe the distinguishing circumstances:

> In this case, the Postal Service has limited the magnitude of its proposed contingency provision for the overt purpose of constructing a constrained revenue requirement in order to restrain the overall level of rate increases as a business objective.
>
> * * * * *
>
> [W]itness Ward defends the proposed 2 percent allowance on the basis of "other valid business considerations. . . . ." [W]itness Ward voices the Postal Service's concern about the "long-term viability of its customer base" [and] . . . postal management's goal of restraining rate increases . . . to create "the opportunity . . . to build [the Service's] revenue base."[6]

In direct testimony, OCA witnesses Burns and Rosenberg outline the contrasting expectations that regulators have for utilities that evidence a determined effort to control

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6 USPS Brief at II-5, *quoting from* PRC Op. R94-1, ¶¶2036 and 2030.

costs, as opposed to utilities that strive to manufacture a large cushion allowing them to avoid aggressive measures to control costs. Witness Burns cautions that:

> Where managers are sheltered from the effects of future events, they make less effort to take actions to control costs. . . . A larger than necessary contingency reserve creates a similar perverse managerial incentive. Managers cushioned from the consequences of controlling costs will tend not to act as aggressively to cut costs and waste. They become lax. This could, and likely would, happen for Postal Service managers if the contingency reserve were raised to a level that exceeds reasonable provision for future, uncontrollable events and thus acts to cushion managers from the consequences of failing to curb controllable costs.[7]

> Witness Rosenberg counsels:

> [I]f the allowed contingency provision is too large, the cushion may result in a tendency toward slackness. This is a form of what economists call moral hazard. . . . [I]t means that the structure of incentives and rewards may not lead to cost minimizing behavior. . . . If the contingency provision is too generous, managers can still meet their breakeven goal in the face of adverse circumstances, without having to make tough decisions. . . . A contingency provision that is overly generous can relieve Postal Service management of the pressure to manage economically and efficiently.[8]

Moreover, the $1 billion dollar cushion is not costless—it comes out of the pockets of postal customers, causing them to suffer an opportunity loss. Businesses and individuals who use the mails at unnecessarily bloated rate levels must forego profitable investments (with rates of return higher than the rates the Postal Service must pay if it borrows money from the U.S. Treasury) and may be forced to borrow money at rates of interest far above Treasury rates. Tr. 22/9828. The opposite condition ensues if the Postal Service chooses to narrow the contingency from higher levels.

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7 Tr. 22/9713-14.

8 Tr. 22/9826-27.

Unintentionally adding further proof of this propensity, the Postal Service cites a passage from a House Report that constitutes part of the legislative history of the Postal Reorganization Act:

> So long as postal management operates with a general awareness that congressional appropriations are always available . . . to make good any shortfalls of revenues or overruns of costs, there is little real incentive to make the best possible use of resources and efficiency is sure to be more honored in the speech than in the observance.[9]

One could easily substitute "contingency provision" for "congressional appropriations" in this quote and do no violence to its meaning—the Postal Service's view of the contingency as a subjective, intuitive "policy judgment regarding the level of risk that can be tolerated"[10] demonstrates that the Service's object is to manufacture a large contingency cushion whose purpose is to shield postal mangers from any adverse consequence arising from an inability to control expenses. Just as Congress recognized in the House report, establishment of a bloated contingency to cover cost overruns and revenue shortfalls destroys any incentive to manage economically and efficiently.

In short, a double standard is eminently reasonable—dramatically higher contingency proposals must be carefully scrutinized (and rejected if compelling evidence is not presented), while contingencies proposed to advance sound business

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9 USPS Brief at II-16, quoting from House Report No. 1104, 91st Cong., 2d Sess. (May 19, 1970) at 16-17.

10 "Responses of United States Postal Service to Questions of the Office of the Consumer Advocate Regarding the Provision for Contingencies," filed May 17, 2000 at 2.

objectives and lighten the burden that must be borne by postal customers should be applauded.

B. Questions Raised by the Postal Service about its Equity Position Are Specious

In its initial brief, the Postal Service emphasizes that its year-to-date net income has declined to $226 million through AP 12.[11] This is followed by the rash speculation that a "typical" AP 13 and AP 14 loss will occur soon after. Also, an allusion is made to the Patelunas roll-forward calculation estimating an FY 2000 loss of $325 million. Rank speculation such as this should be immediately dismissed, particularly since there is ample record evidence that these losses may not occur.

First, the OCA established in its initial brief that the Postal Service's failure to use actual AP cost data for FY 2000 has likely produced a gross overestimate of FY 2000 costs. The OCA cites record evidence to support its calculation of a likely cost of $64.454 billion for interim year FY 2000 (OCA Brief at 18-21). This indicates a likely overstatement of costs by witness Patelunas of up to approximately $700 million (*id.* at 22). Since witness Patelunas' computation of a $325 million deficit stems from a cost estimate of $65.1715 billion (Exh. USPS-ST-44A), a $325 million deficit is highly improbable. Witness Rosenberg expressed strong reservations about the likelihood of such an occurrence. Tr. 41/18307.

Second, witness Rosenberg points out in his rebuttal testimony that a GFY net income figure less favorable than the PFY figure is not inevitable. In the case of FY

11 *See* "Notice of United States Postal Service of Errata to Initial Brief," filed September 19, 2000.

1999, for example, the GFY net income was higher than the PFY net income. *Id.* at 18307-08.

Third, the Postal Service is taking pains to curb expenses at the end of the fiscal year. OCA Brief at 57. If these measures are successful, then the Postal Service may be able to keep costs below budget, as it did in AP 12,[12] and generate a smaller net loss for the accounting period than was budgeted. This, too, was accomplished in AP 12. Also, if the Postal Service's luck holds out, then revenues will be approximately equal to budget projections, as they were in AP 12. In its brief, the Postal Service has clearly exaggerated the bad news and avoided any mention of recent good news.

Finally, the Postal Service's equity position is far better today than it has been in the past. While it is true that its accumulated losses since reorganization now stand at approximately $3.5 billion (through FY 1999),[13] it should be recalled that at the end of FY 1994 they stood at $9 billion. The Postal Service's fiscal health is sound.

C. The Record Is Devoid of Substantial Evidence in Support of the 2.5 Percent Contingency Proposed by the Postal Service

In its brief, the Postal Service blusters that it has supplied substantial evidence to support "postal management's judgment." USPS Brief at II-2. This claim is far from being accurate. Few reasons have been advanced in support of the 2.5 percent proposal, and these few amount to no more than vague apprehensions about possible adverse tendencies in the future.

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[12] Financial and Operating Statement for AP 12.

[13] Tayman Exh. USPS-9L.

The Postal Service sets forth a short list of worries from the Tayman and Strasser testimonies. USPS Brief at II-6-7. For the most part, these uncertainties have been accounted for in the various Postal Service witnesses' cost, volume, and revenue testimonies. A modest one percent contingency is all that is necessary to compensate for any possible misestimation of these amounts. Moreover, the likelihood of misestimation has been greatly diminished due to the substitution of more recent economic forecast information for interim year 2000 and test year 2001 cost estimation.

One reason given by witness Strasser in defense of the $1.68 billion contingency is that Docket No. R2000-1 rate increases will not be implemented any earlier than January 2001. Tr. 46A/20199. However, "[t]he Postal Service filing assumes that proposed rates are in effect for all of the Test Year."[14] In reliance on the exchange that took place between Chairman Gleiman and witness Tayman during Tayman's appearance, the OCA emphatically contends that roughly $425 million of the $1.68 billion contingency requested by the Postal Service must immediately be disallowed. The Postal Service's express intent to use the contingency in lieu of higher rates for the beginning of the test year was not, as Chairman Gleiman pointed out, an unforeseen risk or event.[15] This means that the Postal Service's contingency request really is for $1.255 billion.

The failure of the Postal Service to support an increase in the contingency—even to the $1.255 billion level—leaves open the question of what the correct

[14] Tr. 21/9273 (Postal Service response to interrogatory PSA/USPS-1).

[15] Tr. 2/560-63. The Chairman's statement is consistent with PRC Op. R94-1, ¶2043.

contingency provision should be. It is to this question that the OCA directed its evidence. As discussed in the OCA's Initial Brief (pp. 42-58), the evidence of OCA witnesses Burns and Rosenberg provides substantial and credible support for the continuation of the present one percent contingency provision.

D. Periodicals Should Not Be Relieved of the Contingency Provision or Other Incurred Costs

The suggestion that the Periodicals class be exempted from any contribution toward the contingency was first made in the testimony of American Business Media, *et al.*, witness Morrow.[16] The joint brief of the Alliance of Nonprofit Mailers, *et al.*, defends this novel proposition on brief. ANM Joint Brief at 50-59. The OCA strongly opposes witness Morrow's novel proposal for exempting Periodicals from any share of the contingency and the effort by Periodicals mailers to shift all risk of unforeseen events to the other classes of mail.

Witness Morrow contends that exceptional circumstances attach to Periodicals, warranting the proposed exceptional treatment for them. According to Morrow, these include proposed rate increases far above the average for periodicals,[17] planned cost reductions for processing periodicals that are difficult to quantify,[18] and unexplained cost increases for periodicals.[19]

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16 ABM-T-1; Tr. 29/13542-13560. Magazine Publishers Association witness Cohen joined in this view in her supplemental testimony, MPA-ST-1 (Tr. 38/17072-81).

17 Tr. 29/13549 (ABM-T-1 at 7).

18 *Id.* at 13555-57.

19 *Id.* at 13554.

The factors cited by witness Morrow in defense of the proposal for a zero contingency for periodicals are essentially the same factors that were weighed in the Postal Service's proposed low cost coverage for this subclass. Witness Mayes, in explaining her choice of a near zero cost coverage, explicitly states that the proposed cost coverage for Outside County Periodicals

> has been further reduced due to consideration of the effect of rate increases . . . . Without this consideration, the large increases in unit costs would have led to even higher percentage rate increases for Outside County Periodicals. Despite the objectives of both the Postal Service and the Commission in previous cases to move the cost coverages for Periodicals upward to provide a more meaningful contribution to other costs, the recent increase in costs precludes doing so at this time. USPS-T-32 at 33.

She apparently also took into account (1) Postal Service efforts "to understand what factors may have contributed to increases in flats mail processing costs, especially for Periodicals" and (2) that "[t]he Postal Service is also committed to working with Periodicals mailers to reverse the cost trends of recent years." *Id.* The fairness and equity required of every set of proposed rates,[20] however, clearly bars exempting periodicals both from the contingency and from more than a token contribution to the institutional costs of the Postal Service.[21]

There is, of course, no reason to grant Periodicals mailers special relief from the contingency. As is clear from the Postal Service's Initial Brief, the Postal Service has already made extraordinary efforts to modify its filed case to the exclusive benefit of the

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20 39 U.S.C. § 3622(b)(1).

21 In Section IV of this Reply Brief, the OCA recommends that the minimum cost coverage for any class of mail be established at 105 percent to avoid the potential for any class of mail to under-contribute to the Postal Service's institutional costs.

Periodicals class. While the Postal Service doggedly defends the vast majority of its filed position against other mailers, it urges the Commission to adopt a number of changes to its filed case that benefit only the Periodicals class. Postal Service Brief at VII-137-148. As the Postal Service states, it is now willing to accept "a number of test year cost savings opportunities for Periodicals, beyond those contained in the Postal Service's direct case. *Id.* at VII-139. These changes "would allow the Commission to decrease Periodicals costs by a large amount—approximately $200 million. The Postal Service strongly urges the Commission to make all of these changes." *Id.* at VII-144.

This extraordinary relief effort must be closely examined. If the Commission is inclined to accept any changes, it should be careful that the changes do not adversely affect other classes of mail. Cost reductions that are adequately supported can be made, so long as a corresponding reduction is made in the overall revenue requirement. Other requests, however, should be rejected. The request to use the Baron load-time variability regressions from the new ES study, for instance, would adversely affect other mailers. The OCA strongly opposes the use of the untested regressions. OCA Initial Brief at 135-43.

Furthermore, even apart from the Postal Service's cost relief efforts, there is no reason to single out Periodicals for special relief from the contingency provision. If singular circumstances are examined to determine Periodicals' share of the contingency, each subclass and service must be similarly examined to see whether exceptional circumstances call for an average, above-average, or a below-average share of the contingency. Since the record is devoid of any such assessment, the Commission cannot make the requisite factual findings to do so.

Moreover, if such an assessment were to be performed, it is clear that First Class Letters and Sealed parcels, more than almost any other subclasses of mail, should be relieved of more than just a token share of the contingency. This is because the cost coverage proposed by the Postal Service for this subclass is far higher than that proposed for the majority of other subclasses,[22] and certainly much higher than for the Periodicals class. Postal Service witness Mayes requests a First-Class Mail Letters and Sealed Parcels cost coverage of 197 percent. *See* USPS-T-32 at 20, as corrected April 21, 2000, in Exh. 32B. By contrast, the cost coverage she proposes for Outside County Periodicals is a mere 101.37 percent. *Id.* at 32.

One of the chief purposes of the contingency is to protect against the possibility that estimated revenues will not be sufficient to cover estimated costs. In light of the fact that the rates for First-Class Letters and Sealed Parcels will include such a high cost coverage, it is virtually impossible that this mail will fail to pay for all of its estimated attributable costs. Perforce, to follow the logic of the Periodicals mailers to its conclusion, First-Class Mail would have to be exempted from any significant contribution toward the contingency.

The Outside County Periodicals subclass, on the other hand, with a proposed cost coverage of only 101.37 percent, runs a substantial risk of generating revenues insufficient to cover estimated attributable costs. If different levels of contingency were to be applied to different classes of mail, Periodicals should therefore be made

[22] Express Mail, with a proposed cost coverage of 222.2 percent, and Enhanced Carrier Route Mail, with a cost coverage of 208.8 percent, are two notable exceptions. USPS-T-32 at 28 and 38, respectively.

responsible for an above-average share of the contingency. Exempting Periodicals from any share of the contingency would vastly increase the odds that Periodicals would be cross-subsidized by other classes of mail, such as First-Class Mail, or that Periodicals would disproportionately contribute to the depletion of the contingency if attributable cost estimates for Periodicals are too low.

In its Docket No. R97-1 opinion, the Commission articulated the bedrock principle that: "The intent of the framers of the Act was to prohibit cross subsidies" and that "[r]ecommended rates for each subclass must recover attributable costs, plus a reasonable contribution to institutional costs."[23] The ABM/ANM proposal to exempt periodicals from any share of the contingency would cause the rates for Periodicals to run afoul of both of the requirements articulated by the Commission, *i.e.*, (1) not bearing a proportional share of the contingency increases the risk that the Periodicals subclass will not cover its attributable costs and (2) paying a negligible cost coverage prevents this mail from making a meaningful contribution toward recovery of institutional costs.

For the foregoing reasons, the OCA asks that the ABM/ANM contingency proposal for Periodicals be rejected.

E. The Commission Is Authorized To Determine the "Reasonable Provision for Contingencies"

Several parties have discussed on brief the authority of the Commission to make adjustments to the Postal Service's requested provision for contingencies.[24] These

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[23] PRC Op. R97-1, ¶¶4026 and 4025.

[24] *See, e.g.*, DMA *et al.* Joint Brief Concerning the Revenue Requirement at 3-6; GCA & Hallmark Joint Brief at 29-31; VP/CW Brief at 75-76.

parties correctly argue that the Postal Reorganization Act directly devolves upon the Commission authority to determine the "reasonable provision for contingencies" to be included in the revenue to be derived from rates. 39 U.S.C. § 3621. Certainly the Commission agrees, as its analysis of the *Newsweek* decision in Docket No. R84-1 shows.[25] In this section of argument, the OCA will discuss a further rationale for the Commission's authority to recommend a contingency provision different from that requested by the Postal Service.

If one starts from the assumption, implied in the Postal Service's view of the contingency, that the Commission has *no* authority over the contingency provision, then, as a practical matter, it has no authority over the revenue requirement as a whole. That is because the Postal Service could "game the system" by simply inflating the contingency provision to offset anticipated reductions in other elements of the revenue requirement. The Commission has not exercised its authority to reduce the contingency in omnibus rate cases decided since Docket No. R80-1. This may very well have encouraged the Postal Service to propose a contingency large enough to offset any other reductions in the revenue requirement that the Commission might choose to make.[26] Quite possibly the "contingencies" that the Postal Service is protecting itself against are revenue requirement adjustments made by the Commission, not the adverse external events cited by Postal Service witnesses. In

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[25] *See* PRC Op. R84-1 ¶¶ 1019-47, discussing *Newsweek, Inc. v. USPS*, 663 F. 2d 1186 (2d Cir. 1981), *aff'd sub nom. Nat'l Ass'n of Greeting Card Publishers*, 462 U.S. 810 (1983).

[26] In Docket No. R97-1, for instance, the Commission made various adjustments to the requested revenue requirement for a net reduction of $745 million from the Postal Service's request. Docket No. R97-1 Opinion at ii; App. C.

United Parcel Service v. USPS,[27] the Court of Appeals described a similar Postal Service gaming scheme that was laid bare in the Docket No. R97-1 proceeding:

> After it became apparent that its original revenue estimates were overly pessimistic, the Postal Service reported to the Commission that it would face more costs than it had initially predicted. . . . [T]he Service predicted that it would need $300 million more than it had initially requested for discretionary programs . . . . The Commission rejected what it viewed as attempts to avoid the full impact of the Service's bright economic situation, labeling the new 1.5% contingency number "a plug figure" used by the Service to counterbalance the decrease in the size of its contingency fund . . . . [T]he Commission pointed to a Postal Service document—inadvertently included as evidence and initially disavowed by the Service as inauthentic—that identified the Service's updating "strategy" . . . .

The most reasonable interpretation of 39 U.S.C. §§ 3621 and 3622 is that they should be applied to avoid a regulatory gap. This tenet of statutory construction has often been recognized by the courts. For example, in *FPC v. Transcontinental Gas Pipe Line Corp.*,[28] the Supreme Court held that the Federal Power Commission had jurisdiction to deny a certificate of public convenience and necessity under the Natural Gas Act of 1938. This conclusion rested upon the principle that:

> Congress did not desire an "attractive gap" in its regulatory scheme . . . . [T]herefore, when we are presented with an attempt by the federal authority to control a problem that . . . state regulatory commissions can [not] be expected to deal [with], the conclusion is irresistible that Congress desired regulation by federal authority rather than nonregulation.[29]

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27 184 F.3d 827, 831 (D.C. Cir. 1999).

28 365 U.S. 1, 28 (1961).

29 The Court also noted that this conclusion was consistent with the "broader principle" that Congress "meant to create a comprehensive and effective regulatory scheme," *id.* at 19, *citing Panhandle Eastern Pipe Line Co. v. Public Service Commission*, 332 U.S. 507, 520 (1947). This reasoning was applied in a later case also involving Federal Power Commission jurisdiction—*FPC v. Louisiana Power & Light Co.*, 406 U.S. 621, 631 (1972): "FPC regulation was to be broadly complementary to that reserved to the States, so that there would be no 'gaps' for private interests to subvert the public welfare. . . . '[W]hen a dispute arises over whether a given transaction is within the scope of federal or state regulatory
(continued on next page)

Consequently, the most compelling interpretation of Sections 3621 and 3622 is that they invest the Commission with authority to review and, if necessary, modify a contingency proposal made by the Postal Service to ensure that it is "reasonable."[30] Any other view would open a gap through which the Postal Service could avoid review of its overall revenue requirement.

In Docket No. R84-1, the first omnibus rate case following the Second Circuit Court of Appeals' decision in *Newsweek*, the Postal Service argued that "the Board of Governors of the Postal Service, rather than the Postal Rate Commission, has the *sole* authority to determine the amount of the revenue requirement."[31] Also, according to the Service, the Commission could not make adjustments to the revenue requirement unless objective factual or mathematical errors had been unearthed. The Service made the extreme claim that "the Commission *must* accept the revenue requirement approved by the Board." *Id.*

The Commission disagreed with this restrictive definition of its authority, noting that the most reasonable view of the *Newsweek* opinion was "much less far-reaching" than the Postal service claimed. *Id.* at ¶ 1028. The *Newsweek* holding was premised on the Commission's adopting the role of "disciplinarian." Furthermore, the Commission observed that its failure in that case to explain its departure from past practices was found to be arbitrary. *Id.* at ¶ 1031. Weaving together these

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authority, we are not inclined to approach the problem negatively, thus raising the possibility that a "no man's land" will be created,'" *quoting Transcontinental Gas Pipe Line, supra*, 365 U.S. at 19.

30 *I.e.*, "a reasonable provision for contingencies."

31 PRC Op. R84-1 ¶ 1021. The Commission paraphrased the Postal Service's initial brief.

observations, the Commission concluded that it does have the authority and responsibility to adjust the revenue requirement proposed by the Postal Service so long as adjustments are fully explained and do not encroach upon managerial prerogatives. *Id.* at ¶¶ 1039, 1047. Moreover, the Commission is duty-bound to recommend lawful rates that are accurate and supported by the evidentiary record. *Id.* at ¶ 1045.

It is also important to note three additional circumstances of the *Newsweek* case that are distinguishable from Docket No. R2000-1. The Court of Appeals describes the reductions at issue in the *Newsweek* case ($1 billion) as "staggering." 663 F. 2d at 1192, 1203. This suggests that the Court was concerned about the large proportion of the revenue requirement that the reductions comprised. One billion dollars constituted 4.3 percent of the requested Docket No. R80-1 revenue requirement of $23 billion. PRC Op. R80-1 at 3. The OCA also proposes a $1 billion (rounded) reduction in the requested Docket No. R2000-1 revenue requirement of $67 billion, USPS-9A, constituting a much more modest adjustment of 1.5 percent.

The second important distinguishing circumstance is that the Commission made a downward adjustment from the Docket No. R77-1 contingency allowance of 4 percent to an effective 1.8 percent in Docket No. R80-1. This fact was given considerable weight by the Court:

> The PRC slashed the contingency fund to 1.8 percent . . . . In view of the four percent contingency provision approved by the Board in the last rate case . . . we agree with the Board that the reduction of the fund to less than half the percentage of the previous rate filing was arbitrary.

663 F.2d at 1205. By contrast, the OCA proposes *maintaining* the contingency at its current level, a level fully embraced by the Board of Governors just two years ago.

A third significant difference is that in Docket No. R80-1 the Commission eliminated the recovery of prior years' losses without explanation, an action deemed arbitrary by the Court. *Id.* at 1204. No party has asked for elimination of prior year losses in this proceeding. In fact, witness Rosenberg explicitly cites this cost element as one of the reasons that a moderate contingency provision is feasible. He outlines several "safety nets" that are at the disposal of Postal Service management: (1) *pro forma* estimates of revenues and expenses, (2) the Postal Service's ability to borrow, (3) a new rate request, if necessary, (4) management's ability to control expenses, (5) recovery of prior years' losses, and (6) the contingency. Tr. 22/9819. In view of these options, there is no reason to believe that a reduction in the contingency will "necessarily have th[e] effect" of causing more frequent rate filings, 663 F.2d at 1204, another ground asserted by the *Newsweek* Court for reversing the Commission's action in that case.

In light of the Postal Service's failure to provide credible and substantial evidence in support of its request, the Commission has the duty to make an independent determination of a reasonable contingency. As discussed above and by the other parties on brief, the Commission has the authority to recommend a lower contingency. The evidence presented by the OCA and the other parties strongly supports retaining the present level of one percent. Given the facts of record in this case, such a recommendation would withstand appeal.

II. MAIL PROCESSING VOLUME VARIABILITY SHOULD BE 100 PERCENT

In the following sections, the OCA responds to the Postal Service arguments in support of its volume variability position. The sections first discuss the two fundamental errors in the approach taken in the Postal Service initial brief and other key issues: database deficiencies, the need for a long run study over the rate effective time period, the economic methodologies, and econometric defects. Because of the Postal Service's omission of significant issues in its Initial Brief, the OCA is unable to respond fully to the Postal Service argument on those important issues. The OCA refers the Commission to the OCA's initial brief for a discussion of the significant deficiencies in the Postal Service model relating to QICAP (III.E.1(b) and E.3.(a)) and the need to model the longer-run (III.E.2.(c)).

The Postal Service's initial brief is more telling by the issues that it ignores than by the issues that it discusses. The thrust of the Postal Service argument is that the econometric studies in this record demonstrate conclusively (the Postal Service says "unambiguously") a volume variability for mail processing of less than 100 percent. Although many, but not all, of the studies purport to show volume variability is less than 100 percent, the Postal Service arguments fail to consider important factors and are not persuasive.

A. The Postal Service's Initial Brief Contains Two Fundamental Flaws

The Postal Service's Initial Brief has two fundamental flaws--it assumes an accurate underlying model of mail processing, and it assumes that the longstanding policy of the Commission must be changed if the Postal Service only shows that volume variability is probably less than 100 percent.

1. The Postal Service's initial brief erroneously assumes its model accurately reflects mail processing operations

The first of the two fundamental deficiencies in the Postal Service's dissertation is that the Postal Service erroneously assumes that its econometric model accurately reflects mail processing operations. The model does not do so inasmuch as the underlying theories and economics are deficient. The Postal Service studies are based upon an incorrect application of economics. There also continue to be deficiencies with the data underlying the study. The Postal Service has failed to adequately respond to the primary thrust of the Commission's objections to the fixed effects model previously compiled in the Docket No. R97-1 opinion. The Commission criticized the appropriateness of the model. It also criticized the model's handling of variables; both those variables that vary with respect to volume and those variables that are not affected by volume (the control variables).

The Postal Service's initial brief primarily attempts to dispel witness Neels' criticisms.[32] The brief is misleading and somewhat disingenuous in stating, "Only one intervenor witness offered conflicting analysis of Postal Service operation, UPS witness Neels." USPS Brief at V-13. The Postal Service knows very well that OCA witness Smith's testimony conflicted with witness Degen's analysis. The OCA is a participant in the proceeding and, technically, not an intervenor. The Postal Service's statement may be technically accurate, but, nevertheless, it is misleading and ignores extensive criticism in this record of witness Degen's comments.

The Postal Service brief ignores the significant issue raised during the hearings concerning the inappropriate specification of the capital variable in the model, QICAP. It also totally ignores discussion of the longer-run expansion path that is so significant for an understanding of why the longer-run measurement of costs (across facilities) is important. Without resolving these theoretical issues, conclusions are meaningless, both regarding which specifications are preferable (*e.g.*, models A, B, or C as defined in NOI No. 4)[33] and what are the computed values of the variabilities.[34] The Postal Service brief also ignores other significant issues relating to the omission of variables that are necessary for a complete analysis; *e.g.*, capacity utilization, certain network characteristics, and physical characteristics of the processing facilities such as floor space, age of facility, and number of stories in processing facilities.

2. The Postal Service must demonstrate more than a probability that variability is less than 100 percent

Another fundamental flaw in the Postal Service's initial brief is the assumption that the Postal Service only needs to demonstrate that variability is probably less than 100 percent to compel the Commission to scrap its present policy. That is not the case. The Supreme Court has made clear that the selected method of costing must attribute

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32 The Postal Service devotes the following sections in response to witness Neels (USPS Brief, Section V: pages V-13-21[§1a]; V-23-26[§1c]; V-37-40[§§1f-g]; V-42-44[1i]; V-47-49(§1jiii); V-50-61(§1l-o).

33 Notice of Inquiry No. 4, "Concerning Mail Processing Variability Models," August 2, 2000.

34 NOI No. 4 response of witness Smith, Tr. 46E/22363-69.

to a given class costs that are *reliably identifiable*. This model does not reliably identify the mail processing costs attributable to the given classes. The burden is on the Postal Service to demonstrate that a change in policy is warranted. The Commission does not have a basis on which to select a specific variability from this record with any assurance that it is reaching the correct result.[35]

Assume, *arguendo*, that the Commission prefers to adopt the Bozzo model. The disadvantages of using an incomplete study are not outweighed by the advantages. The several studies in the record compute very different point variabilities for each MODS pool. Some variabilities computed by the Postal Service are not significantly different from 100 percent, and witness Neels found variabilities in excess of 100 percent. In fact, even two of witness Bozzo's ten recommended estimated variabilities are very close to 100 percent (89.5 percent for BCS cost pool and 95.4 percent for the LSM cost pool).[36]

Postal Service witness Greene testified that, in his view, a variability of 85 percent is significantly different from 100 percent, but he agreed the percentages of 95.4 and 89.5 are not percentages that are substantially less than 1. He did not know whether they are the right variabilities for those pools. Tr. 46E/22088. He also testified

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[35] *National Association of Greeting Card Publishers v. U.S. Postal Service*, 462 U.S. 810, 820 (1983). *See also*, OCA Brief at 92-3. The Periodicals Mailers' brief contends that if the Commission declines to recognize that a considerable portion of mail processing costs are not volume variable, it is not free under the *National Association of Greeting Card Publishers* case to apply a 100 percent volume variability as there is no substantial evidence to support such attribution. Rather, it says, the costs must be treated as institutional costs. Periodicals Mailers Brief at 40-1. The Periodicals Mailers fail to recognize the substantial record evidence in this case supporting the 100 percent variability and do not give adequate deference to the Commission's long-standing policy of mail attribution.

[36] Bozzo, Direct testimony, USPS-T-15, Table 6 at 119.

that he just did not have the expertise about certain specific activities in mail processing to know whether the recommended variabilities were substantially less than 100 percent. Tr. 46E/22089.

Some of the alternative "between" regression results computed by witness Bozzo for the letter and flat sorting operations have variabilities for the most significant cost pools (BCS, OCR, FSM, MANL, and MANF) generally well above 90 percent.[37] The variabilities from those regressions are not significantly different from 100 percent. If the vast majority of mail processing costs relate to cost pools with probable variabilities close to 100 percent, there is no justification to change the current policy that is so easily understood and applied.

The record is clear that adjustments to witness Bozzo's model would change the computed variabilities. Variabilities change with the choice of variables and the choice of computational technique. Witness Bozzo claims variabilities would not be increased to as high as 100 percent, but the true impact of corrective adjustments is unknown. Nevertheless, re-modeling could increase even the low variabilities recommended by witness Bozzo (the most significant are now in the 70 or 80 percent range) upwards so that they would probably not be significantly different from 100 percent.

Even witness Bozzo's recommended variabilities, with a distribution of two standard errors, are either not significantly different from 100 percent or very close to

[37] Bozzo, Direct Testimony, Appendix E, "Principal results from the 'between' regression model" Table E-1. This is also true for Table E-3 at 155 in the same appendix except that the small LSM pool has an estimated variability of 87.3 percent, extremely close to 90 percent. *See also*, witness Neels' Direct testimony, Tr. 27/12834-35, 12839-40.

being not significantly different from 100 percent. The following chart compiled from the variabilities with two standard errors included in witness Bozzo's testimony is illustrative.

Cost Pool	Variability Point Est.	Standard Error	Lower Range	Upper Range
BCS	0.895	0.030	0.835	0.955
OCR	0.751	0.038	0.675	0.827
FSM	0.817	0.026	0.765	0.869
LSM	0.954	0.022	0.910	0.998
MANFLATS	0.772	0.027	0.718	0.826
MANLTRS	0.735	0.024	0.687	0.783

Source: USPS-T-15, Table 6 at 119.

In addition, other record evidence is directly contrary to the Postal Service's contention. For instance, witness Neels found variabilities in excess of 100 percent. Tr. 27/12807-08, 12834-43. Witness Neels also concluded that variabilities higher than those determined by the Postal Service cannot be ruled out. Tr. 27/12839.

The Periodicals Mailers' proposal for selecting volume variability estimates based on the range of values between the pooled and fixed effects models is flawed. Periodicals Mailers Brief at 45-48. The models are incorrectly specified, and such a bracketing of estimated variabilities ignores the ranges of the point estimates within each model: the 99 percent confidence bands for many of the volume variability estimates are very close to 100 percent volume variable in the case of the pooled and "between" models. Periodicals Mailers' selective choice of models to advocate variability goals is wrong.

For these reasons, the Postal Service is in error if it expects that, by merely computing volume variabilities of less than 100 percent, it necessarily justifies altering the Commission's long-standing policy. This is particularly true where the model used as an estimator is subject to so many deficiencies and relies on a questionable database. Accordingly, the variability studies recommended by the Postal Service should not be accepted by the Commission as support for altering its 100 percent volume variability policy.[38]

B. The Postal Service Has Not Demonstrated that Mail Processing Costs Are "Unambiguously" Less Than 100 Percent

The Postal Service has presented witnesses Degen, Bozzo, Greene, and Kingsley in support of various aspects of the volume variability study. The Postal Service's initial brief details how their testimony supports the volume variability study.[39] Although each of the witnesses presented information relevant to mail processing, they did not collectively succeed in establishing that mail processing variabilities are unambiguously less than 100 percent.[40]

Witness Degen, "who has studied Postal Service operations since 1983" (USPS Brief at V-11) is cited as having provided an analysis of Postal Service mail processing

[38] Just as the Commission and the Chief Examiner found in Docket No. R71-1, the statistical analysis in this case must be rejected in favor of the 100 percent volume variability because no party has presented a viable alternative. USPS-T-15 at 8.

[39] The Postal Service Brief discusses the testimonies of Degen at V-11-21, Bozzo at V-23-62, Greene at V-35, 45, 52 and 55-59, and Kingsley at V-31 and 37.

[40] Postal Service witness Greene testified that he really could not say that the data analyzed in the studies contain the specific value of volume variabilities. Tr. 46E/22086. He also confirmed that from the testimony he has read, a specific value for any of the activities has not been conclusively determined from this record. Tr. 46E/22085.

operations and concluding that mail-processing costs are less than 100 percent volume variable. *Id.* Actually, witness Degen's testimony is largely of the descriptive, anecdotal genre.

Witness Degen provided comprehensive descriptions of mail processing operations, focused on mail flows in the processing plants, the characteristics of the operations, and the effect of the characteristics on the ability of the workers to absorb changes in volume with less than proportional changes in workhours. USPS-T-16 at 10-54. Witness Degen's analysis describes operating practices on the factory floor, presenting "the operational foundation for volume variability." Witness Degen "explains that network and location-related factors affect costs, but do not change with volume . . . ." In short, he ignores changes in activities in a mail processing facility and the addition and/or modification of mail processing plants. Clearly such an analysis can correctly identify costs over a relatively short period of time (at the lower limit, less than a day), but is irrelevant for the longer run analysis of cost causation.

Likewise, in the case of gateway staffing, witness Degen explained "that gateway operations are generally capable of more throughput than the downstream operations. The time spent waiting for mail in gateways does not increase as volume increases. Rather, it will tend to be converted into processing time, as there is more mail to handle." USPS Brief at V-16, citing USPS-RT-5 at 14, Tr. 38/17319. The Postal Service states that, "Mr. Degen does not claim that a sustained increase in workload would not require more work hours, as Dr. Neels implies, but rather describes the means by which the change in work hours need not be 100 percent volume-variable." USPS Brief at V-17. The Postal Service also references both witnesses Stralberg and

Kingsley to corroborate many of the facts cited by witness Degen. USPS Brief at V-18. The amount of effort devoted to discussing operating windows, setup and breakdown, and sorting leads to the conclusion that witness Degen is considering short-run costs. One would expect to see such costs have less than 100 percent volume variability; however, they are not the relevant costs which should be analyzed.

On a short-run basis, witness Degen is obviously correct in assuming that costs have less than 100 percent variability. In fact, his analysis is descriptive of a one day, short-run time frame.

Contrary to the Postal Service's claim, witness Degen's testimony is not unambiguous. The conclusion of witness Degen, cited to support the Postal Service argument, is "volume-variabilities are *generally* less than 100 percent" (emphasis supplied).[41] Note that witness Degen's testimony ambiguously hedges, stating only that variabilities are "generally" less than 100 percent. The Postal Service notes in its initial that a further qualification lies within witness Degen's testimony. The Postal Service states that witness Degen concludes it is "likely" that "volume-variabilities are generally less than 100 percent . . . ." USPS Brief at V-11, USPS-T-16 at 2.

This testimony does not demonstrate unambiguously that variability is less than 100 percent. In fact, it demonstrates just the opposite: that even the Postal Service witnesses are not certain of the conclusions.

[41] Postal Service Brief at V-II, *citing* USPS-T-16 at 51.

1. The Postal Service has not demonstrated that setup and takedown times will not increase proportionately over the longer run

The Postal Service contends that setup and takedown times will not increase proportionately with increases in mail volume and thus concludes that mail processing times cannot possibly vary 100 percent with mail volume. USPS Brief V-14-5. The OCA would agree that the nature of mail processing sort schemes accompanied by setups and takedowns may lead to variabilities less than 100 percent on a short-run basis. Witness Kingsley is quoted on the unavoidability of setup and takedown times associated with bundle sorting operations. USPS-T-10 at 21. Witness Stralberg indicated that with larger volumes the runs of each scheme would be longer. This would result in the cost of setups being spread over additional mail pieces. Tr. 38/17280. However, those situations described are of a short-run nature.

Witness Neels has contested witness Degen's contention that setup and takedown times insure that volume variability is less than 100 percent. Tr. 27/12820-24. Before responding to the Postal Service's specific comments refuting witness Neels, it is necessary to first emphasize that the straightforward and direct answer is included in Neels' testimony. The Postal Service is looking at the short run rather than the longer run. If one machine requires one hour of setup, then as volume increases so that a second machine is required, two total hours of setup will be required. Tr. 27/12822-24.

The Postal Service cites three aspects of witness Degen's responses to witness Neels on the setup and takedown times. None are responsive, as they either concede too much or miss the point. The argument of the Postal Service is that setup and takedown times involve relatively fixed costs that do not change with new volume. It follows, goes the argument, that when volumes increase, all costs do not increase proportionately. The cost of the same number of setups would be spread over more mail pieces.

The Postal Service agrees that setup times do sometimes change, but that it is due either to response to "growth" in deliveries more than to mail volumes and to the deployment of new automation which is "not always" tied to volume changes. But this is beside the point. No one is contending that setup times never change in response to other factors. However, witness Degen admits that setup times are responsive to changes in volume, even if that is not always a reason for the change. USPS-RT-5 at 12. In fact, some setup times do change in response to some new deployments that occur due to changes in volume. It is not unreasonable to find a proportionate increase in setup times. For example, during ramping up periods, setup times can be greater than normal. Also, the setup times for new equipment could actually be greater than the setup time for the older equipment. New technology does not necessarily mean shorter setup times. In fact, common experience suggests more complicated equipment probably has, in most cases, longer setup times.[42] The Postal Service also establishes automated or mechanized processing activities to meet increased mail volume where they had not previously been established. Tr. 27/12781. The addition of new setup times would clearly lead to a more than proportionate increase in setup and

[42] Witness Neels depicts the cost effect of this process very clearly in Figures 1 and 2 of his direct testimony, Tr. 27/784-86.

takedown time for those activities and is a reflection of the impact of the longer-run outlook.

The Postal Service refutes witness Neels' suggestion that setup times may increase in a stepwise fashion. It says this "does not specifically imply 100 percent or any other particular degree of variability." USPS Brief at V-14. In fact, the Postal Service's statement is in direct conflict with witness Neels' own testimony. On the same page of its brief it cites witness Neels' statement that: "[r]eplication of setup and takedown times in response to continuing growth could create a situation in which costs increase in a stepwise fashion *in direct proportion to volume.*" USPS Brief at V-14 (emphasis supplied), *citing* Tr. 27/12822. Thus, Neels' testimony specifically refutes the Postal Service's argument. The Postal Service further claims that witness Neels' own studies do not demonstrate variability is less than 100 percent. USPS Brief at V-14. Again the Postal Service confuses the issue. As witness Smith has often said, the underlying models are flawed, and this is true even of witness Neels "alternative shape-level analysis" which will not measure the appropriate longer-run variability. There is no reason to expect that the flawed model would produce 100 percent variabilities.

The Postal Service also says, in support of its theory that setup times do not increase in proportion to volume, that the direct determinant of the number of setup and takedowns is the "need to change mail processing sort schemes, *not* mail volume." It also states that "[n]etwork considerations affect the number of schemes, and there is no simple relationship between volume and scheme changes." USPS Brief at V-14-5.

Again this defense misses the attack. The Postal Service does not carry its analysis far enough. It admits that network considerations also affect the number of sorting schemes, but forgets to recognize that those network considerations themselves can be caused by increases in volume. The Postal Service also points to individual instances where there are increases in setup schemes that are not volume related, but they ignore situations where setup and takedown times may be volume related and may increase more than proportionately.[43] For instance, disproportionate setup and takedown time increases could occur if there were mail processing bottlenecks that prevented the setups or takedowns from occurring for particular machines precisely when necessary. Also, additional and disproportionate setup and takedown times can be required to run new equipment being added in response to new volumes. This may not necessarily last only during the ramping up phase, but could occur permanently as new, more complex equipment may require longer set up times than older machines.[44]

2. Witness Degen's explanation of how mail is processed does not prove 100 percent volume variability

Witnesses Stralberg and Degen present interesting information on the mail handling process. The Postal Service states:

> Mr. Degen and Mr. Stralberg are both convinced that hours in mail processing operations do not vary 100 percent with volume, and, along with witness Kingsley, have cited numerous facts in support of that conclusion. The Commission should accept their well-founded conclusion that mail-processing costs are not 100 percent volume-variable. USPS Brief at V-21.

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[43] It is well settled that Postal Service equipment is added to meet increases in volumes. See Tr. 27/12777-82.

[44] Even if setup times on a new machine are longer, it does not follow it is less efficient. The throughput may be so much greater that the unit costs will decrease.

In fact, the witnesses have not presented an analysis of volume variability; they have, instead, made a presentation on how mail is processed. Their comments are focused on the short-run time frame, generally addressing the types of operational accommodations made during a mail processing shift. These are very different cost analyses from those of the longer run. The Commission cannot fairly conclude that the mail processing costs are unambiguously less than 100 percent.

3. Volume variability is not unambiguously 100 percent volume variable when witness Neels' presentation is recognized

The Postal Service is misleading in contending that witness Neels' "own alternative analysis of those data yields variabilities significantly lower than 100 percent." USPS Brief at V-130. One can turn to witness Neels' direct testimony and find activity variabilities well in excess of 100 percent for 7 of 8 cases. Tr. 27/12834, 12840. One can only speculate as to the level of variabilities if witness Bozzo's flawed analysis were corrected. It is clear that neither witness Neels nor witness Smith agree with witness Bozzo's conclusions.

The Postal Service maintains that "[a]ll of the reliable statistical evidence in the record points to mail processing variabilities being less than 100 percent and differing by operation." USPS Brief at V-23. The Postal Service references various models in the Notice of Inquiry No. 4 and in witness Bozzo's direct testimony. In fact, all of the models are variants of witness Bozzo's original analysis and are subject to the theoretical deficiencies mentioned in witness Smith's testimony and also discussed by witness Neels. The Postal Service has designated the pooled model results as being statistically reliable. USPS Brief at V-25. Even using the pooled model, subject to the theoretical deficiencies of witness Bozzo's approach, six of the ten variabilities (BCS, OCR, FSM, LSM, MANF, and MANL) are within, or close to, two standard deviations of 90 percent. Loosely stated, the pooled model suggests volume variabilities of at least 90 percent. Dr. Greene has indicated that 90 percent variability could, for practical purposes, be considered to be 100 percent. Tr. 46E/22088. Put differently, even the Postal Service presentation does not strongly support variabilities less than 100 percent.

Furthermore, it should be noted that the Postal Service's initial brief did not reference witness Neels' analysis that attempted to correct some of the deficiencies in witness Bozzo's study. As previously stated, witness Neels found variabilities in excess of 100 percent for some operations. The Postal Service states, "[a]ll of the witnesses agree that the result of mail processing labor variabilities less than 100 percent is possible. Nothing in Dr. Bozzo's modeling approach precludes results of 100 percent volume-variability." USPS Brief at V-26. In fact, from a theoretical viewpoint, variabilities well in excess of 100 percent are also possible.

C. <u>Witness Bozzo's Analysis Is Incorrect</u>

The study, developed by witness Bozzo, has been cited for a variety of major flaws: for instance, witness Bozzo's database has been scrubbed to the point that the production of high R^2 equations is inevitable. He utilizes a microeconomic methodology that is theoretically flawed and which produces short-run estimates of volume variability (one year or less), a matter of increasing concern given that rates are in effect for two to four years. In addition, witness Bozzo uses an estimating procedure that ignores important variables (such as capacity utilization), treats endogenous variables as exogenous (such as the Manual Ratio and QICAP), and is conducted at the wrong level of analysis (the activity rather than the plant or system level). This ignores the long-run expansion path and still has not resolved the issue of whether the fixed effects are truly fixed.

1. The appropriate manner to scrub the data remains unresolved

The Postal Service has stated that "Dr. Neels does not expressly claim that Mr. Degen's analysis is incorrect . . . ." Brief at V-13. However, witness Neels does, in fact, find that witness Bozzo's study is deficient. He concluded that some of witness Bozzo's coefficient estimates were subject to error in variables bias, even after witness Bozzo's data scrubs had been performed Tr. 46E/22336. He also concluded that "I have substantial issues with the specification of the model and the approach and the things they don't take into account . . . ." Tr. 46E/22356. "And I frankly don't think there is a good solid consensus estimate out there, or something that is robust enough that it would warrant a decision to move away from the 100 percent volume variability." Tr. 46E/22356-57. The uncertainties surrounding the appropriateness of the data scrubs are alone sufficient to warrant rejection of witness Bozzo's variabilities until the appropriate handling of the data can be resolved.

2. A short-run analysis is irrelevant

The Postal Service has again maintained that, "[t]he variability analysis must be appropriately 'short run' to fill its role in the Postal Service's overall cost analysis." USPS Brief at V-40. The Postal Service brief discusses that labor planning can occur on a daily basis, or over a year, thereby advocating the use of a SPLY model. USPS Brief at V-39. A SPLY analysis, however, is a cyclical analysis--looking at where the mail processing operation stood at the same time a year ago. The OCA has shown that the longer run encompasses at least a period as long as the rate effective time period, a period bounded at the lower end by a time frame of the several years between rate cases.

The Postal Service witnesses have confused the discussion by claiming that their short-run estimator is identical to that associated with the expansion path discussed by witness Smith. Tr. 38/17384, 27/13189, 46E/22199-00. In fact, the two are different; one is short run and the other is long run. They do not have the same variability. Witness Smith testified, "Finally, the modeling should have been performed on a long-run basis, focused on the facility expansion path." Tr. 46E/22367.

In short, the Postal Service has not presented the type of cost analysis that permits adequate analysis of mail processing costs. Relevant volume, operational, and investment decisions occur over a span of two to four years, the relevant time frame for a rate case.[45] Allowing for some overlap with rates on both sides of the analysis, the relevant time period for analysis is two to four years.

[45] Deputy Postmaster Nolan's August 21, 2000 interview by PostCom indicated "We do not have a plan to implement new rates every year, every two years, or every five years. There is no such plan . . . .We don't have a specific plan to raise rates every two years or anything like that . . . . I think people would like more frequent, more predictable rate cases but they don't want them every year." USPS LR-I-492 at 3.

D. Witness Bozzo's Mail Processing Model Is Not Based on the Appropriate Economic Theory

The Postal Service continues to be wrong on the underlying economic theory. The Postal Service maintains that the labor demand function should be specified at the activity rather than facility level. USPS Brief at V-29. This contention is directly contrary to the Postal Service's own arguments that workers can be shifted around the plant, that the continued use of the manual ratio is maintained (the manual ratio is based on the interrelationship of activities), and that the capital investment variable, QICAP, is based on facility wide, not activity wide, capital.

1. Witness Bozzo has not selected appropriate variables

It is stated that witness Bozzo identifies "the factors that sufficiently bridge the gap between generic theory and operational reality." USPS Brief at V-30. Yet he ignores capacity utilization (a potentially important cost driver). Capacity utilization has been cited as a possible driver of costs (Tr. 27/13185) and witness Degen has described how labor usage rises and falls as additional letters arrive (thereby using capacity) or do not arrive (creating idle time) on a short-term basis. In neither case has witness Bozzo analyzed the longer-run cost causation, the period over which capital equipment decisions are implemented.

Witness Bozzo has also ignored the use of a simultaneous equations approach as needed for the estimation of the labor demand function. In stating that "volume does not cause network characteristics," USPS Brief at V-31, the Postal Service ignores that the configuration of machines in the internal plant network is largely driven by mail sortation requirements.

2. Network and location-related factors do change with volume, but that fact is not reflected in the assumptions underlying the Postal Service model

The Postal Service's network analysis erroneously assumes that network and location-related factors do not change with volume (although, at least, the Postal Service does now recognize that these factors affect costs). The Postal Service states that "Dr. Bozzo's analysis appropriately distinguishes volume and non-volume factors that determine costs in the operations studied." USPS Brief at V-37. In fact, witness Bozzo's only network characteristic is the number of delivery points. There is no consideration of the configuration of machines in a mail processing plant based on mail volumes, no consideration of the addition of machines and plants to the network to meet volume changes, and no consideration of the interaction of mail processing plants. In short, the discussion of networks is minimal.

Witness Degen's analysis of the effects of national volume growth fails to recognize that network and other location related factors change with volume. The Postal Service's Initial Brief states very clearly that this is Mr. Degen's position. USPS Brief at V-12. This is contrary to common sense and ignores the interrelationship of the activities within the facility. Tr. 27/12793. Volume growth at the local level can result in changes in the network both within the facility and across facilities. For instance, as volume grows within a plant so that expansion to an annex is necessary, most certainly there will be an impact on the internal network operations of a particular facility. As a plant modifies its facilities, the operations must be modified. Likewise, if a new facility is constructed as a result of local volume growth to eliminate a processing bottleneck at a particular facility, the old facility may modify its network or coordinate its processing with the new facility in a way that modifies the network. All this is a result of volume growth. Witness Smith discusses this in his testimony:

> Mail processing activities and sites do not stand alone in terms of the network of originating and destination nodes. There seem to be three types of network issues. First, there is the intra-plant network of activities that feed mail to each other. One gets the impression that this network could change based on a variety of factors, including network volumes. A second type of network effect is apparently the delivery configuration of the service territory. Dr. Bozzo measures this network configuration with a variable measuring the number of possible deliveries. Finally, the position of the plant in the mail flow between other mail processing plants also seems to be a type of network relationship. According to an interrogatory response, the size of facilities and their mail processing operations depends not only on the volume of mail processed, but also their position in the Postal Service's network. Tr. 27/13193 (footnote omitted).

Witness Neels also discusses networks and notes that new plant construction plays a part in the response of the Postal Service to an increase in mail volume. Tr. 27/12790. The omission of these variables is significant; for as witness Bozzo has so clearly stated, "Omitting relevant variables from a regression leads to bias." Tr. 46E/22154.

3. In maintaining that TPF is a proper measure of mail processing volumes, the Postal Service ignores that TPF is not an accurate <u>measure of the volume of mail</u>

In maintaining that TPF is a proper measure of mail processing volumes, the Postal Service ignores that TPF is not an accurate measure of the volume of mail. TPF may be measured with great precision, but it is not accurate in portraying the actual volume of mail. Various criticisms of the precision with which FHP can be measured have been made; such measurement is clearly open to improvement if necessary. However, the inability to measure precisely the amount of mail is different from the inability to measure accurately. See USPS Brief at V-32.

E. The Cross Sectional "Between" Model Is the Only Model that Considers Differences Between Facilities Based on Size and Volumes

The Postal Service correctly notes the statistical problems with the cross-sectional model. USPS Brief at V-34. However, the Postal Service conveniently fails to mention that the cross-sectional model is the only one offered by witness Bozzo in the current case that adequately considers the differences in costs between facilities based on different sizes and volumes. The Commission has discussed the desirability of such an approach:

> In particular, the rate cycle production period implied by the theoretical framework described in the previous section requires an estimation procedure which relies on persistent differences in the mode of operation across facilities, rather than differences in mode operation within the same facility over short time horizons. Differences in the operation of facilities of different sizes would more accurately reflect the relationship between volume and costs that would occur over a production period as long as a rate cycle than would differences in the operation of the same facility over adjacent time periods. Consequently, an estimation procedure which primarily relies on the cross-sectional dimension of the panel dataset is preferred to one that relies on differences over time within the same facility, such as the fixed-effect estimator. PRC Op. R97-1, Appendix F at 13-14.

The volume variabilities from the "between" model are, in general, not statistically different from 100 percent in many cases, and are high in other cases.[46] Recognizing that the cross sectional "between" model shares many of the deficiencies of witness Bozzo's other models, it has been proposed as the "least bad" model, not as a good model. Problems in specifying a "good" model highlight the need for the

[46] The variabilities are in Appendix E of witness Bozzo's Direct Testimony, USPS-T-15.

formation of a working group to resolve modeling and other issues in a collaborative environment.

F. A Working Group To Address Modeling, Economic and Estimation Problems Is Recommended

Numerous deficiencies in witness Bozzo's study have been outlined in testimony and the OCA's initial brief. The Postal Service has not adequately addressed modeling, economic, and estimation problems. Given the amount of effort and time devoted to this effort, it would be desirable to salvage as much of the work as possible. Accordingly, for this reason OCA has recommended the establishment of a working group to consider the appropriate modeling of mail processing.

III. THE COMMISSION SHOULD APPLY ITS ESTABLISHED ATTRIBUTION METHODS TO THE ES-BASED ESTIMATE OF ACCRUED LOAD TIME COST

The OCA has proffered a consistent and reasonable approach for attributing city carrier load time costs in this proceeding. As outlined in the OCA's initial brief, this approach includes the following components: (1) use the accrued load time costs flowing from the carrier street time proportions developed from the Engineered Standards ("ES") as the basis for the load time analysis; (2) apply the elasticities from the Load Time Variability study ("LTV") regressions to estimate elemental load time; and (3) attribute residual load time costs after elemental costs have been estimated (*i.e.,* coverage-related costs) based on the proportion of mail volumes delivered to single subclass stops. This approach combines the use of updated and fully-reviewed street time percentages and related accrued load time costs with the application of well-established methods for assessing the volume variability of these costs and attributing them to appropriate mail classes.

A. The Commission Should Accept the Postal Service's ES-Based City Carrier Street Time Proportions

In this case, the Postal Service has presented new estimates of the street-time percentages used in the segment 7 cost analysis that are based on the recently completed ES study. Postal Service witnesses Raymond and Baron, along with supporting testimony submitted by NAA witness Kent, Tr. 39/17877-88, provide convincing arguments in support of the new street-time proportions. USPS Brief at V-70 to -80. In particular, these proportions are reflective of current carrier street activities and based upon an extensive, two-year study that employed advanced data collection technology to record these activities. Although certainly not without flaws, it is apparent from the record that ES-based street-time percentages are reliable for ratemaking purposes and represent an improvement over the percentages derived from the 1986 Street Time Sampling study.

B. The Commission Should Continue To Employ LTV-Based Elasticities To Derive Elemental Load Time

Participants in this proceeding, primarily the Postal Service and Advo, *et al.,* offer varying alternatives for estimating elemental load time. For example, in its direct case, the Postal Service, through witness Baron, argued for applying LTV-based elasticities to ES-based accrued load time costs to estimate elemental load time costs.[47] The OCA

[47] Response of witness Baron to Interrogatorry UPS/USPS-T12-13, Tr. 46D/21098-99; MPA Additional Designations, August 16, 2000. The Postal Service neglects to mention this in its initial brief.

agrees with the Postal Service that it is appropriate to use the LTV-based elasticities in conjunction with the ES data.

Subsequent to the filing and defense of witness Baron's direct testimony and after the filing of intervenor direct testimony, however, witness Baron and the Postal Service changed the Postal Service's proposal. The Postal Service is now encouraging the Commission to abandon the LTV regressions in favor of an alternative regression developed by witness Baron that is based on the ES data. USPS Brief at V-80-81. Advo *et al.* also support the use of the ES-based regressions, but only if the Commission chooses to employ the ES-based street-time percentages. Advo *et al.* Joint Brief Concerning City Carrier Cost Attribution ("Joint Brief") at 17.

The arguments of these parties in support of the ES-based regression are unpersuasive. The Postal Service argues that the ES-based regression provides results that are more operationally feasible compared to the LTV-based regressions. USPS Brief at V-81. This point fails to recognize, however, that the original specification of the model and related data produced nonsensical results. USPS-LR-I-310, pp. 7-9. The record does not indicate whether the final regression proffered by witness Baron is appropriately correlated with the underlying data or simply a product of strong-arming the regression into a state of apparent reasonableness.

Advo *et al.* point to the fact that no intervenor party filed testimony expressing opposition to the application of the ES-based regression. Joint Brief at 17. This void in the record is not surprising, however, given the late arrival of the proposal. Furthermore, it is important to recognize that no intervenor filed testimony showing comprehensively and quantitatively why the Commission should employ the ES-based regression. Indeed, even the primary intervenor witness advocating for its use, MPA witness Crowder, admits that she has not investigated the ES model thoroughly nor considered possible alternative specifications. Tr. 32/16224; *see also* OCA Brief at 135-37.

In sum, the ES-based regression represents an entirely new methodology for assessing the volume variability of load costs by replacing the stop-level LTV regressions with a route-level analysis. In assessing its application, the Commission has nothing but a mixed bag of interrogatory responses and evolving library references submitted by witness Baron to rely upon. While OCA agrees that it is important to update the LTV regressions, the evidentiary record clearly does not support the use of the ES-based regression for ratemaking in this proceeding. Accordingly, the Commission should follow the general approach used by the Postal Service in its direct case—apply the LTV-based elasticities to the ES-based accrued load time costs to derive elemental load time costs.

C. The Commission Should Continue To Attribute Coverage-Related Load Time Using Single Subclass Stop Ratios

For the past four rate proceedings, the Commission has attributed the residual portion of load time costs (*i.e.*, those costs remaining after elemental costs have been calculated) on the basis of the single subclass stop methodology. In this proceeding, the Postal Service purports to have shown why this approach is flawed. USPS Brief at V-82-97. Its argument, however, depends upon the conclusion that costs can only be attributed on a marginal cost basis. As such, the Postal Service attempts to develop a method for assessing the volume variability of coverage-related costs and critiques the "residual" approach from that perspective.

The Postal Service's method fails in two critical ways. First, it clings to a worldview of cost attribution that has long been refuted in Commission precedent. This precedent firmly establishes that the Commission is not obligated to rely exclusively on volume variability analysis in identifying cost causation, and furthermore, has a statutory obligation to attribute costs when their causation can be reliably identified.[48] In the case of residual coverage-related load time costs, the Commission has identified a useful technique for establishing a link between these costs and particular subclasses of mail. It is irrefutable that costs incurred to deliver a single subclass of mail to a particular stop are caused by that subclass. Second, and even if one assumes that a volume variability analysis of coverage-related load time is appropriate, OCA witness Ewen has shown convincingly that witness Baron's efforts to construct such an analysis are, by definition, flawed and incorrect. Tr. 25/12032-43. For these reasons, the Commission should not depart from the established method of attributing residual coverage-related costs.

IV. COST COVERAGES FOR SUBCLASSES SHOULD BE SET AT A MINIMUM OF 105 PERCENT

The Postal Service has requested extremely low cost coverages for certain subclasses of mail. The Commission, however, should resist the temptation to set rates

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[48] *See, e.g.*, PRC Op. R94-1, ¶¶ 3095-3152.

at levels so close to attributable costs that the revenues may not actually recover all such costs. Attributable cost estimates that underlie rates are not perfect. Consequently, no one can ever know with certainty whether rates do in fact cover the attributable costs of a class or subclass. This problem is exacerbated when last-minute changes in costing methodology occur. In its initial brief, the Postal Service has set out a long list of costing changes that it either commends for the Commission's consideration[49] or "would not challenge."[50] If the Commission should adopt any of these changes, it should also set cost coverages for affected subclasses reasonably above 100 percent.

The Postal Reorganization Act requires each subclass of mail to bear its own attributable costs. 39 U.S.C. § 3622(b)(3). The Act also requires each subclass to make a "reasonable" contribution toward covering the other costs of the Postal Service. *Id.* The Commission has interpreted this section as prohibiting cross-subsidization. PRC Op. R97-1 ¶¶ 4026-27. However, the Commission has also recognized that the realities of cost and revenue estimation preclude it from meeting these standards with absolute certainty. PRC Op. R94-1 ¶¶ 3084-92. The resolution of this conflict between statute and reality requires that cost coverages be set reasonably in excess of 100 percent. Only then can it be said that postal rates and fees meet statutory requirements with a reasonable degree of certainty.

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49 USPS Brief at I-18 to -28.

50 *Id.* at 24.

Hardly any expense of the Postal Service can be traced directly from the books of account to a particular subclass. And it is impossible to follow each piece of mail through the postal network to determine the exact value of the resources needed to get each piece from origin to destination. Consequently, the Postal Service uses sampling systems to determine the costs of the various classes and services. Unfortunately, as witness Fronk testified, "Sampling error usually accompanies sampling estimates." Tr. 34/16583. And the Commission itself has taken note

> of the general proposition that cost coverages near 100 percent provide little leeway in terms of meeting the attributable cost floor. The Commission is aware that very low markups might, in fact, result in rates below attributable costs. It is not possible on this record to adopt a formal statistical technique to use as a guide. The Commission, however, has avoided extremely low markups whenever possible.

PRC Op. R94-1 ¶ 3088.

Data collection or analysis is not a perfect science. Errors can creep into the IOCS or the CCS or any other cost data system. Data can be recorded incorrectly, computers can be programmed incorrectly, and analysts can blink at the wrong time. Such errors arise whether one takes a sample or a census. Mistakes of these types are referred to collectively as nonsampling error.

In this proceeding, the Postal Service has acknowledged committing nonsampling error and has warned the Commission that undiscovered errors may lurk in the roll-forward update provided in response to Order No. 1294. USPS Brief at I-9. In spite of its own warnings, the Postal Service is urging the Commission to adopt certain hastily constructed changes in cost allocation procedures. Some of these changes are unlikely to survive closer scrutiny by the Postal Service itself. The

Commission should exercise great caution when evaluating the Postal Service's revised cost allocations, especially where the Postal Service calls attention to the fact that a proposed change will reduce attributions to a particular subclass. By calling attention to the fact that certain costing changes may benefit a particular subclass, the Postal Service raises the possibility that the integrity of its cost allocation systems has been compromised. Even if no intentional bias has crept into them, the haste in which the revised costing procedures were devised should alert the Commission to the possibility of nonsampling error.

In Docket No. R94-1, the OCA proposed adjusting extremely low cost coverages upward in order to account for sampling error. The Commission rejected the proposal because the data needed to implement it did not exist. However, as noted above, the Commission did express its recognition of the need to avoid cost coverages close to 100 percent whenever possible. In the current proceeding, the Commission faces an increased probability that low cost coverages will lead to rates that do not cover costs. Certainly such rates will contribute little to the substantial institutional costs of the Postal Service. Sampling error still exists in cost estimates, and nonsampling error is now higher. By whatever means necessary, the Commission should ensure that all subclasses have cost coverages reasonably in excess of 100 percent. A cost coverage floor of 105 percent will provide greatly increased probability that all subclasses cover their true costs and contribute at least something to the institutional costs of the Postal Service, thus avoiding cross-subsidy and unfair burden on those classes that are assigned a high coverage of their attributable costs.

V. FIRST-CLASS RATE ISSUES

A. The 33-Cent Single-Piece First-Class Rate Should Be Retained

In this proceeding, the Postal Service and certain other parties argue that the Commission should reject OCA's proposal to retain the current 33-cent single-piece First-Class Letter rate, as an alternative to the proposed 34-cent rate.[51] Those parties make numerous arguments objecting to OCA's effort to reduce the very high institutional cost burden on First-Class Mail in this proceeding by retaining the 33-cent rate.[52] Similarly, the Major Mailers Association ("MMA"), while highlighting the disproportionate First-Class institutional cost burden, nonetheless supports the 34-cent single-piece rate, but seeks an increase in worksharing discounts to reduce that burden for large-volume business mailers.[53]

Neither the Postal Service, nor other parties opposing OCA's proposal, dispute the fact that the institutional cost burden on First-Class Letter Mail proposed in this proceeding is very high by historic standards. Rather, they attempt to rationalize the existence of that institutional cost burden, maintain that past Commission statements are irrelevant, or claim that OCA witness Callow's testimony is somehow legally deficient, thereby precluding the Commission from recommending retention of the current 33-cent rate. However, no amount of rationalizing or arguments can justify the

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[51] Initial Brief of the United States Postal Service at VII-29; Initial Brief of Association for Postal Commerce and Mail Advertising Services Association International at 9; and Brief of the Direct Marketing Association, Inc. at 5.

[52] In fact, the institutional cost burden on First-Class Letters, as measured by the mark-up index, exceeds that of Priority Mail—the Postal Service's supposedly premium mail service.

[53] Initial Brief of Major Mailers Association at 6.

very high First-Class Letter institutional cost burden, and the Commission should retain the current 33-cent rate in order to reduce that institutional cost burden in this proceeding.

Witness Callow examines the growth in the institutional cost burden of First-Class Letter Mail since 1988 as measured by the mark-up index. OCA Brief at 144-47. Using an average of the Commission's recommended First-Class Letters mark-up index from the four rate cases during this period, witness Callow concludes that First-Class Mail has contributed revenues to institutional costs in excess of that intended by the Commission in its past opinions. *Id.* at 152. The excess institutional cost contributions are also apparent when the actual First-Class Letters mark-up index is compared to the Commission's recommended mark-up index, rather than the average over the four rate cases. *Id.* at 152-53.

The Postal Service fails to address the historically high institutional cost burden it has proposed for First-Class Letters in this proceeding, arguing instead that the percentage rate increase for First-Class is below the rate of inflation. USPS Brief at VII-30. It suggests the lower rate increase is caused by changes in the First-Class mail mix prompted by new worksharing incentives and the success of the Postal Service's automation program. *Id.* In effect, the Postal Service acknowledges the declining costs of First-Class Mail, but unless such declining costs are reflected in the rate, the institutional cost burden will continue to grow relative to the institutional cost burden of other mail classes.

PostCom advances a similar argument. It explains that differences in the implicit cost coverages of single-piece and presorted First-Class exist because projections of the mix of mail differ from those actually observed, causing the subclass-wide cost coverage to increase. PostCom Brief at 12.

These arguments miss the central point of witness Callow's testimony that the First-Class institutional cost burden continues to advance inexorably—even as costs decline and the rate increases below the rate of inflation. Moreover, the Postal Service and PostCom seem to suggest that somehow knowing that the mail mix has changed, resulting in different implicit cost coverages, makes an ever higher First-Class institutional cost burden more palatable to mailers.[54] This ignores the overall effect of shifting the institutional cost burden to First-Class Mail—expecting the class of mail widely used by the public to carry an ever-greater share of the Postal Service's institutional costs.

The Postal Service further argues that witness Callow's analysis is somehow flawed in that he uses the test year cost coverages and resulting mark-up indices recommended by the Commission in past cases during each year in which the rates for each case were in effect. According to the Postal Service,

> the Commission's opinions only address cost coverages during specific test years for each omnibus rate proceeding and not the intervening years. While the Commission's intentions for the Docket No. R90-1, R94-1, MC95-1 and R97-1 test years are known, one can only speculate as to what cost coverages the Commission might have found acceptable for the intervening years. USPS Brief at VII-30.

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[54] PostCom notes that there are implicit cost coverages for different rate categories in every subclass of mail. PostCom Brief at 12. This is beside the point. With respect to First-Class Letters, the Commission declined to formally recognize those separate cost coverages by recommending separate subclass status for single-piece and presort in its Docket No. MC95-1 Opinion and Recommended Decision, making any discussion of implicit cost coverages moot.

The Postal Service apparently fails to understand, intentionally or otherwise, the meaning of witness Callow's testimony. Witness Callow states that he "interpret[ed] the test year as a period that is intended to be typical or representative of (*i.e.*, an average for) the period that recommended rates are in effect." Tr. 22/10173. In fact, the concept of a test year makes little sense if it is not considered representative of the period during which rates are in effect. That is, for any given multi-year period, if the goal is to "break even" during the period in which rates are in effect, then the rates based upon test year costs must permit the Postal Service, through honest, efficient, and economical management, to "break even" in that period. In effect, the test year must represent an average.[55] Indeed, a common pattern for the Postal Service is to make money in the first year, see revenues equal costs in the second, and lose money during the third year. Consequently, the relative contribution recommended by the Commission for the test year should represent the average contribution per year during the period in which the rates are in effect. For this reason, there is nothing wrong with witness Callow's use of the Commission's recommended mark-up index as the measure of institutional cost contribution, and its expression of intent for the entire period the recommended rates were in effect.

The Postal Service and DMA argue that the Commission cannot recommend the current 33-cent rate in this proceeding because "witness Callow provided the Commission with no practical guidance [with respect to the pricing criteria] for reaching

[55] The easiest way to see this is to look at what happens if the test year is known, *a priori*, *not* to be an average of the period that rates will be in effect: a deviation from break-even is then inevitable. But such a deviation is prohibited.

such a result." USPS Brief at VII-31; DMA Brief at 6. OCA's initial brief discusses in detail all the relevant pricing criteria. OCA Brief at 155-60. Moreover, it should be noted that the First-Class mark-up index inherent in the current 33-cent single-piece rate, based upon OCA's proposed costs, incorporates all the factors of the Act. That mark-up index is 1.353 in the test year after rates. OCA Brief at 156. In this manner, witness Callow's proposed mark-up index provides guidance to the Commission, as it can be compared to past Commission recommended First-Class mark-up indices, as well as the Postal Service's proposed First-Class mark-up index of 1.422 in the test year at 34 cents. OCA-LR-I-3, Part I, Table A.

The Postal Service argues that "[r]etaining the current 33-cent rate essentially would require that all other mail classes and postal services bear much of the burden of the increased revenue requirement." USPS Brief at VII-11. To the contrary, other alternatives exist. OCA has proposed that the revenue requirement be reduced by shrinking the Postal Service's excessive contingency request. OCA Brief at 39-58. Consequently, not *all* classes or postal services would have to bear the burden of reducing the First-Class Letter Mail institutional cost contribution. Nevertheless, some sharing of the institutional cost burden is appropriate. Thus, some burden should be distributed to commercial Standard Mail in order that First-Class and commercial Standard Mail have roughly equivalent mark-up indices, as intended by the Commission in past opinions. OCA Brief at 148-49.

With respect to MMA's desire to expand workshare discounts,[56] the OCA takes no position on the proper level of discount, as OCA's proposal is focused on the single-piece user. OCA Brief at 160. Nevertheless, it should be noted that retaining the 33-cent single-piece rate would achieve the lower institutional cost burden sought by MMA, and provide very substantial rate relief to First-Class business mailers.

B. CEM Should Be Recommended

The Postal Service has again trotted out the same tired arguments it has been using against CEM since Docket No. R87-1. These arguments have been shown to be unsound in the past and they are unsound today. CEM is a well-researched, well-documented service that will be valuable to consumers. CEM aligns cost and price more optimally and will give consumers a choice. Individual mailers will be able to benefit directly from the Postal Service's investment in automation.

1. The classification issue has long been decided

The Postal Service argues that CEM does not meet the statutory criteria of Section 3623(c). USPS Brief at VII-34-37. This is absolutely untrue. In Docket No. R97-1, the Commission recommended the following DMCS language to the Governors:

> 221.25 Courtesy Envelope Mail Rate Category. The courtesy envelope mail rate category applies to Letters and Sealed Parcels subclass mail in envelopes that:
>
> a. Are preaddressed and preprinted reply envelopes, of a design approved by the Postal Service;

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[56] The American Bankers Association and the National Association of Presort Mailers also seek larger workshare discounts without taking a specific position on the appropriate single-piece First-Class rate. ABA/NAPM Brief at 5-20.

> b. Bear a facing identification mark as specified by the Postal Service;
>
> c. Bear a proper barcode corresponding to the correct ZIP Code, as specified by the Postal Service;
>
> d. Bear an indication that the envelope is eligible for the discount, as specified by the Postal Service; and
>
> e. Meet automation compatibility criteria as specified by the Postal Service. PRC Op. R97-1, App. 2, pp. 9-10, § 221.25.

The consistency of CEM with the Section 3623(c) requirements is not an open question. It was decided by the Commission in Docket No. R97-1. It was also decided by the Commission in Docket No. MC95-1. Indeed the exact same classification language was recommended by the Commission in Docket No. MC95-1. PRC Op. MC95-1, App. 2 at 9. Clearly this argument is old news.

Surprisingly, the Postal Service again makes the equity argument to withhold the benefit of CEM from consumers.

> For households, the reduced rate would be a complete windfall, because in reality they would do nothing more than continue to mail the envelopes that someone else has provided them. Equity suggests that households should not receive the benefit of their low-cost CEM mail until they are asked to pay a surcharge to cover the costs of their high-cost mail. USPS Brief at VII-44.

The Commission has made clear that the mailer, not the provider of the envelope, should receive the benefit. PRC Op. R90-1 at V-55-57. CEM envelopes have been saving the Postal Service processing and delivery costs for the entire period during which the automation program has been in place. In addition, the cost of processing even hand-written mail has been going down. Tr. 14/5938-39. Finalization of mail before it is sent to a Remote Encoding Center ("REC") continues to improve. The finalization rates have increased from 32.7 percent in FY 1998 to 58.5 percent in

FY 2000 (YTD AP 7). Tr. 7/3080. There is no basis to withhold the benefit of cheaply processed envelopes from consumers.

2. The Postal Service's reliance on the Ellard survey is still misplaced

The Postal Service continues to argue that the public—purposefully kept in the dark by the Postal Service—has no interest in CEM.

> As fundamental a change as CEM would represent to the mailing practices of the general public, it would seem imperative that the Commission and the Governors have a very high level of assurance that its adoption was something the public actually preferred. USPS Brief at VII-37.

The Postal Service claims that witness Willette agreed with witness Ellard's Docket No. R97-1 research concerning the dreaded "two-stamp" problem. Agreement is completely different than acknowledging that there *may have been a valid point* in the Postal Service research. Witness Willette went on to explain that the research was inconclusive and, therefore, no reason to withhold choice of a lower rate from the public.[57] Indeed, the Commission found the research inconclusive and stated that it was less than definitive on CEM's appeal, thus dismissing witness Ellard's assertion that it proved consumers did not want CEM. PRC Op. R97-1, Vol. 1 at 324, ¶5189. The Postal Service has claimed that the Ellard research constituted proof that consumers did not want to be offered a discount to mail bills and other courtesy reply pieces. The plain truth is that the Postal Service does not want to give consumers a choice. No one (except the Postal Service) has suggested that CEM be mandatory.

[57] Tr. 23/10738. *See* also Tr. 23/10782.

Consumers are capable of making choices; if they do not want to use CEM postage stamps, they will not use them.[58]

3. Education funds have already been set aside

The Postal Service contends that any "CEM enforcement program would need to be coupled with an education program designed to educate the public." USPS Brief at VII-39. In Docket No. R97-1, the Commission included $33 million in the revenue requirement to educate consumers in the use of CEM. Over the two years rates from Docket No. R97-1 will be in effect, that amounts to $66 million. The Postal Service is already in possession of the funds it seeks. Since the Postal Service has been given these funds as a result of Docket No. R97-1, there is no need to allocate them again.

4. The confusion issue is a red herring

The Postal Service would have the Commission believe that consumers are fragile creatures, easily confused by postage stamps. USPS Brief at VII-38-39. That, as they say in Texas, is hogwash! The OCA has addressed this issue. OCA Brief at 175. Consumers choose among a large number of alternative products and services every day. It is called competition. If the Postal Service thinks consumers cannot understand two postage stamps for two different envelopes (one of which says "CEM Postage Allowed" and one of which does not), then choosing a long distance carrier or

[58] The Postal Service relies on witness Willette's discussion of some aspects of CEM at a conference to claim that witness Willette agrees with the Postal Service on consumer interest. USPS Brief at VII-37. To the contrary, the major point made by witness Willette at the Vancouver Postal and Delivery Economics Meeting in June 2000 was that since the Postal Service had resisted CEM since Docket No. R87-1, the opportunity to use it effectively to stem diversion to electronic media may have been lost by now. Electronic bill paying and ordering have become less costly and more convenient during the period of more than a decade since CEM was first proposed.

a cellular telephone service provider must be impossible. The Postal Service is acting as a monopolist—tailoring and restricting its service offerings to suit its convenience, rather than proactively offering consumers choices that would make mail service more attractive and relevant to them. The Postal Service (which claims that it must compete) should begin to act like a competitor and provide consumers with choices instead of assuming that they lack intelligence.

5. Enforcement can be managed

Enforcement is again trotted out as a reason to reject CEM. USPS Brief at VII-40-42. Enforcement is an issue throughout the Postal Service and it has been an issue since the Postal Service started to charge rates. So long as the Postal Service charges rates, enforcement will be an issue. There are some mailers who, knowingly or not, apply the wrong amount of postage. Witness Willette testified that in general "if the cost of enforcement exceeds the underpayment of postage, then the underpayment would be tolerated." Tr. 23/10786. This is a rational economic point of view. Spending $70 million to collect $10 million in underpaid postage, as the Postal Service suggests, is irrational and no sane manager would allow it to happen. OCA Brief at 179-80. The data on the record of this proceeding show that customers overpaid postage in 1999 by $204.6 million. Tr. 21/9112-13.

6. Administrative costs are exaggerated and based on faulty reasoning

The Postal Service imagines the worst possible world if CEM is adopted. Operations are at risk and a costly administrative nightmare will ensue. USPS Brief at

VII-43. These objections are the result of seriously flawed reasoning. OCA Brief at 176. There is no reason to assume that trips to post office windows will double. Consumers are capable of adjusting habits at a much faster pace than the Postal Service is willing to admit. Certainly most consumers would rather not spend more time standing in line to purchase stamps. Fortunately there are other ways to obtain stamps, *e.g.*, by mail or over the internet. In addition, consumers who find the notion of two stamps unattractive probably would not bother to purchase both denominations. Whenever this happens—that is, when consumers do not purchase CEM stamps—the Postal Service will receive mail with overpaid postage. If the Postal Service *is* correct about the lack of interest in CEM, then implementing it would change nothing.

7. The CEM proposal is the most researched proposal

Several parties have proposed discounts for First-Class Mail in this proceeding. Pitney Bowes has proposed a discount for users of postage meters. Tr. 29/13893. Stamps.com and E-stamp have proposed a discount for users of PC postage.[59] In addition, the American Bankers Association and the National Association of Presort Mailers have jointly proposed the establishment of a new category of First-Class Mail that would be collected by private firms and presorted to lower its processing costs. Tr. 26/12436-42. None of these discounts has had the benefit of over a decade of research and development. CEM has been thoroughly examined by the Commission, and the Commission is satisfied. It has been demonstrated to the satisfaction of the

[59] *See* Tr. 29/13650-51 and Tr. 23/10478-80.

Commission that CEM is a sound proposal that will not harm the financial well-being of the Postal Service. The same cannot be said of these new and relatively untested proposals.

The Commission has acknowledged that CEM is a viable consumer service. The revenue consequences to the Postal Service are not large or financially threatening. CEM would offer consumers a choice. CEM also would promote good will for the Postal Service among consumers.

The arguments against CEM are uniformly without merit. The Commission was not persuaded by the Postal Service's disingenuous arguments in Docket No. R97-1 and should not be persuaded by them now. The Postal Service arguments have been put to rest, one by one. The time has come to move ahead and implement CEM. Consumers need to see a Postal Service that is responsive to their needs

C. The Commission Should Recommend the One-Pound Priority Mail Rate for the Flat Rate Envelope

As established in Docket No. R97-1, the current Priority Mail rate for a one-pound or a two-pound envelope or package, and for the special flat rate envelope, is \$3.20. In Docket No. R2000-1, the Postal Service proposes a separate one-pound Priority Mail rate of \$3.45 and a two-pound rate of \$3.85 for any envelope or package, and proposes to apply the two-pound rate to the special flat rate envelope. This would result in an unacceptably high rate increase of 20.3 percent for the flat rate envelope user. Intervenor Douglas Carlson argues that such an increase is not justified, and that the flat rate envelope should be charged the new one-pound rate. Carlson Brief at 1-9. The OCA agrees.

If the Commission recommends the Postal Service approach, the rate for the popular flat rate envelope will no longer be the lowest Priority Mail rate available. Flat rate envelopes are convenient to the public while offering two significant benefits to the Postal Service—a high postage payment relative to the average weight of pieces mailed and a uniform, machinable mailpiece that is easy to handle. The change requested by the Postal Service, however, undermines the convenience of a flat rate. As such, it disturbs the balance between the benefits to the public and to the Postal Service from use of the flat rate envelope.

Until recently, customers could place as much mail material as would fit into a free specialized flat rate Priority Mail envelope, apply the lowest Priority Mail postage (currently $3.20), and conveniently drop the envelope into any USPS pick-up box. Unfortunately, times have changed, and security is such that postal customers must now present mail weighing more than one pound to a USPS window clerk. If the Postal Service succeeds with its two-pound rate request, the only remaining customer convenience is a free envelope. As Mr. Carlson points out in his Initial Brief, the envelope alone is not worth $0.40 to consumers. Consequently, the intrinsic value of a flat rate envelope is significantly diminished. Carlson Brief at 6.

In support of his proposal to use the one-pound rate for the flat rate envelope, Mr. Carlson notes that 77 percent of all flat rate envelopes weigh one pound or less and, in fact, 29 percent weigh three ounces or less. Carlson Brief at 1. The Postal Service calculates the average weight of all flat rate envelopes to be only 10.3

ounces.[60] On average, then, the Postal Service currently collects $3.20 for mail that could be sent by First-Class Mail for $2.53.[61] The average weight is significant: a flat rate should adequately compensate the Postal Service for the average piece mailed for the rate, not just the relatively few pieces at the higher end of the weight range of flat rate envelopes.

Flat rate envelopes have been widely accepted by the public. They comprise 10.3 percent of all Priority Mail volume and an astonishing 56.2 percent of all Priority Mail volume for pieces weighing four ounces or less.[62] Just within flat rate envelopes, pieces weighing four ounces or less comprise 35 percent of the total.[63] Pieces weighing four ounces or less, however, can be sent by First-Class Mail for $0.99 or less. Business mailers are unlikely to pay the current Priority Mail $3.20 rate to mail only a few ounces (when First-Class rates are much cheaper), which indicates that consumers are using flat rate envelope for light mailpieces, either for convenience or for the perception of premium service. By overpricing the flat rate envelope compared to its average weight (two-pound rate vs. 10.3 ounce average weight), the Postal Service would unfairly decrease the value of the offering to consumers. The Postal Service

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60 USPS-LR-I-165, filename USPST34A, Worksheet "Input Data", cell D155.

61 Because of the 13 ounce limit on First-Class Mail, the maximum charge for a piece sent First-Class is currently $2.97.

62 USPS-LR-I-165, filename USPST34A, Worksheet "Input Data" indicates that in FY 1998 there were 75,728,918 Priority Mail pieces weighing between 0-4 ounces, of which 42,552,090 were flat rate envelopes (56.2%). For all weights, there were 119,934,151 flat rate envelopes out of a total of 1,167,814,341 Priority Mail pieces, or 10.3%.

63 *Id.* (42,552,090 ÷ 119,934,151.)

should not overcharge consumers for their acceptance of the convenience of the flat rate envelope.

To the extent some consumers choose Priority Mail because of the perceived premium service, the customer's perception of Priority Mail may be changing. During cross-examination, USPS witness Mayes responded to a question posed by Commissioner Goldway regarding the hierarchy of USPS mail services. Witness Mayes claims that customer perception of Priority Mail service relative to competitive services has altered. Tr. 11/4600. Certainly, Postal Service data show that the actual service performance of Priority Mail lags that of First-Class Mail.[64] Under the circumstances, there is no basis to charge a high rate based on premium service

As Mr. Carlson points out, customers mailing lighter weight Priority Mail pieces (under one pound) pieces will not generally be inclined to pay the additional $0.40 just for the privilege of using the Postal Service's "special" flat rate Priority Mail envelope. Customers can purchase an envelope for much less than $0.40, and will likely do so to save on Priority Mail postage when their mailpiece weighs less than one pound. When the customer abandons the Postal Service's uniform, machinable Priority Mail envelopes, the Postal Service loses one of the advantages of providing uniform packaging. Machinable mail, however, is exactly the type of mail the Postal Service should be encouraging customers to provide them.

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[64] In FY 1999, 93.3 percent of First-Class Mail met a one-day standard versus 90.4 percent of Priority Mail; for a two-day standard, it was 86.5 percent for First-Class Mail but only 79.3 percent for Priority Mail. Tr. 21/8857; *see also* Tr. 11/4602-06.

The Postal Service's pricing strategy lacks foresight. Pricing the flat rate Priority Mail envelope higher than the lowest rate available and at a weight increment not representative of the predominant use of flat rate envelopes, will doom the Priority Mail flat rate envelope to obsolescence.[65]

The OCA supports Mr. Carlson's proposal to set the flat rate at the one-pound rate. This would be a more modest increase of 7.8% (at the Postal Service's proposed rate levels). Using the one-pound rate for flat rate Priority Mail envelopes benefits everyone. The Postal Service would get more machinable mail and higher postage payments. Customers, meanwhile, would get a product more in line with their actual use and needs. Given the lower service performance of Priority Mail in relation to First-Class letter mail, a more modest increase in the flat rate Priority Mail envelope fee is certainly warranted.

D. The Commission Should Rely on the "As-Filed" Methodology to Forecast the Number of Additional Ounces in First-Class

The Postal Service struggles mightily attempting to justify the "revised" methodology by refuting the analysis of witness Callow in support of the "as-filed" methodology—the methodology originally proposed by the Postal Service to forecast the number of additional ounces of single-piece First-Class Mail. USPS Brief at VII-15-

[65] Mr. Carlson argues that the Postal Service is likely to create a new Priority Mail envelope similar to the current flat rate envelope, but which would be weighed and rated. Carlson Brief at 7, *citing* Tr. 7/2872. This is an unnecessary complication. If the one-pound rate is applied to the flat rate envelope, the Postal Service will need only one envelope. The only change required would be to state that the one-pound rather than two-pound Priority Mail postage is to be applied. To the extent that customers use older envelopes after the new rates are in effect, and mistakenly apply the two-pound postage, the Postal Service will benefit. Certainly, however, the fact that existing envelopes specify the two-pound rate is not a substantive reason to apply that rate once a one-pound rate is in existence.

19. However, Postal Service efforts cannot shake what is clear from the evidence in this proceeding: the long-term trend in the number of additional ounces is rising, and the "as-filed" methodology produces a forecast that best reflects that trend. The Commission should not be swayed by the Postal Service's self-serving efforts to offset its error correction of the overpayment of First-Class postage by adopting the "revised" methodology to forecast the number of additional ounces.

The Postal Service hopes that the Commission will choose the "revised" methodology by referencing the fact that the Commission has used the "revised" methodology previously. USPS Brief at VII-17. This is irrelevant. The Commission should adopt the methodology that best reflects the rising long-term trend in the number of additional ounces. In this regard, witness Callow shows that the number of additional ounces per piece forecast by the "as-filed" methodology tracks "almost exactly" the long-term trend line projected through to the test year. OCA Brief at 162-63. By contrast, the "revised" methodology results in zero growth through the test year. *Id.* at 167.

The Postal Service chastises witness Callow for not "taking into account how historical events might have affected the data" presented on the long-term trend in the number of additional ounces; specifically, the sharp increase in additional ounces between 1994 and 1995, and 1997 and 1998. USPS Brief at VII-67. Witness Callow explains that his analysis shows that even if the years with large increases are ignored (and only the other years are considered), the long-term trend in the number of additional ounces is still rising, although the rate of increase is not as great. OCA Brief at 163.

Moreover, the Postal Service places great emphasis on the fact that these sharp increases, or alternatively, "one-time events," will not occur in the test year. USPS Brief at VII-68. Use of the long-term trend takes into account the fact that new, "one-time" events that drive-up the number of additional ounces are likely to happen again. As the data show, there were two "one-time" events in the past decade. The Commission's increase in the additional ounce weigh limit to 13 ounces from 11 ounces in Docket No. R97-1 will likely have the same effect in the future.

Finally, the Postal Service takes issues with witness Callow concerning his view that the lower rate of growth in additional ounces in recent years may be a function of "sampling error." USPS Brief at VII-69. The Postal Service appears comforted by the fact that sampling error also affects the historical data over the period 1990 through 1998. *Id.* As explained by witness Callow, the existence of sampling error is most problematic for estimates based on small samples (or limited periods of time). Tr. 36/16905. Consequently, the Postal Service's estimates of the number of additional ounces based upon the two most recent years of data may not be representative of the long-term trend. *Id.*

In summary, what is apparent from this episode is that the "as-filed" methodology was thoroughly analyzed and determined to be proper, with the full backing of postal management, when it was originally filed as part of the Postal Service's request in this proceeding. Postal Service efforts to disavow the "as-filed" methodology now ring hollow as the time elapsed between the original filing and introduction of the "revised" methodology did not appreciably increase the amount of data on which the Postal Service now claims its decision is based. The only conclusion to be drawn is that the "revised" methodology was rehabilitated in order to offset the $192.3 million in total net revenue occasioned by the Postal Service's necessary correction of the overpayment of First-Class postage.

E. The Commission Should Eliminate the Nonstandard Surcharge for Low Aspect Ratio

In its initial brief, the Postal Service expresses the belief that the nonstandard surcharge acts as an incentive to use standard-size letters. Accordingly, "the primary objective of the surcharge is to provide to those who are able to do so sufficient incentive to design mail pieces so that they contributed to operational efficiency." USPS Brief at VII-21. Unfortunately, the Postal Service's belief cannot compensate for the lack of information on the response of mailers, or reliable data on what problems, if any, nonstandard low aspect ratio letters present in the current automated processing environment.

The Commission should eliminate the nonstandard surcharge for low aspect ratio letter mail. It is apparent from the evidence in this proceeding that such mail does not create problems for postal mail processing equipment, and Postal Service claims to the contrary lack support. Retaining the nonstandard surcharge for low aspect ratio mail simply perpetuates an unfairness for which the Postal Service cannot document a problem.

In this proceeding, the Postal Service claims that "witness Miller has updated the nonstandard surcharge cost estimates and addressed several issues that were raised in Docket No R97-1." USPS Brief at VII-82. In reality, the Postal Service has simply contributed more verbiage, revealing Commission criticisms from Docket No. R97-1 to be as valid today as when its opinion was issued. PRC Op. R97-1, ¶¶ 5226-5228. As was the case in Docket No. R97-1, the Postal Service is again hobbled in its efforts to justify the surcharge by the lack of basic data on costs and processing—with the same result. Witness Miller again relies on proxies for estimating cost differences between the processing of standard and nonstandard one-ounce pieces. USPS Brief at VII-19. Witness Miller again assumes all manual processing of nonstandard mailpieces, given "the absence of any empirical data which indicated the degree to which nonstandard pieces [footnote omitted] can be processed on automation." *Id.* at VII-19-20. However, according to the Postal Service, this assumption has little effect on total costs of nonstandard mail. *Id.* at VII-20. Moreover, the precise measure of costs of nonstandard pieces (or generation of revenues) is not necessary in pursuit of the primary "objective." *Id.* at VII-85; *see also Id.* at VII-21.

Witness Callow shows that the unit costs for low aspect ratio letter mail are affected by the assumption of all manual processing. OCA Brief at 195-96. Using a more realistic assumption that at least 50 percent of low aspect ratio letters are presented for automated processing, *id.* at 191-93, witness Callow develops unit costs that are lower than the surcharge. *Id.* at 197. Moreover, witness Callow calculates that the revenue loss to the Postal Service from eliminating the surcharge on low aspect ratio letters is minimal—approximately $6.9 million. *Id.* at 199. The Postal Service also believes the revenue loss is "not the issue." USPS Brief at VII-85. Consequently, the surcharge should be eliminated for low aspect ratio mail as a matter of fairness, as mailers pay extra for mail that receives little (if any) additional processing. OCA Brief at 200.

In an effort to challenge the notion that low aspect ratio letter mail is not a problem for automated processing equipment, the Postal Service states that witness Callow fails "to appreciate the distinction between machinability and the capability of equipment to read addresses and apply barcodes." USPS Brief at VII-84. The Postal Service relies on "machinability test results" from the mid-70's. *Id.* There is no dispute that low aspect ratio letters exhibiting barcodes have been successfully processed through the "outgoing" primary operation. Tr. 7/3225; *see also* USPS-T-24 at 21. What the Postal Service fails to appreciate is that the application and reading of barcodes is a form of "machinability" in that low aspect ratio letters are being processed, at least partially, through the mail processing network. To the extent such letters are delivered without a "Postage Due" marking, they have been processed through the entire automated processing network. That is the evidentiary (not sentimental) value of witness Haldi's small-scale experiment with seasonal greeting cards presented in Docket No. R97-1—the absence of any Postage Due markings means there was no manual processing. OCA Brief at 194.

Moreover, the absence of a postage due marking means that neither the individual mailer nor the recipient know that low aspect ratio letters are "nonstandard" for processing purposes. *Id.* at 199. Consequently, individual mailers have no incentive to increase the volume of low aspect ratio nonstandard letters entered as collection mail. *Id.* Similarly, the Postal Service claims that mailers need to be discouraged from designing low aspect ratio letters by retaining the surcharge. USPS Brief at VII-85. Such claims are unpersuasive as they lack any support. Presumably, the Postal Service is referring to business mailers, whose mail matter includes bills, statements of accounts, and important correspondence, among others. Business mailers are economically motivated to design mailpieces that move efficiently though the entire mail processing network to ensure timely delivery of these important documents. In effect, business mailers have no incentive to do otherwise, since any possibility that such letters may not be processed timely would discourage the volume the Postal Service fears.

F. Criticism of the OCA Rate Stability Proposal Is Misguided

The Postal Service's comments on the OCA rate stability proposal are circumspect: the Postal Service encourages the Commission to "shelve" the proposal but acknowledges that the "reserve account idea is not uninteresting." USPS Brief at VII-88. The Postal Service, however, considers development of such a plan to be related to "the management of postal finances and accounts and rate implementation policy," and best left to the discretion of the Postal Service. *Id.*

The Postal Service also contends that the idea is premised upon the Postal Service moving to a two-year rate cycle. *Id.* at VII-87. To counter the widespread statements of postal officials that the Postal Service expects to implement new rates again in 2003, the Postal Service cites the belatedly filed Library Reference USPS-LR-I-492. This consists of an interview conducted by the Association for Postal Commerce in late August with Deputy PMG John Nolan, and posted on the PostCom website on or about September 1, 2000. In the interview, Mr. Nolan says that there is no plan to implement new rates at any specific time.

Library Reference USPS-LR-I-492 is unsolicited and is not sponsored. It is not in the evidentiary record of this case, and its use by the Postal Service on brief as a statement of Postal Service policy must be disregarded. Moreover, the interview appears to be an effort by Mr. Nolan to muddy the waters about his prior public statements to large mailers that rates will change again in 2003. Many of these large mailers are encouraging the Postal Service to put rate changes on a more regular basis so as to have smaller, more frequent and predictable rate changes.[66] Certainly, the present case will change rates after only two years.

However, the effort by the Postal Service to keep everyone guessing about the timing of future rate changes is largely irrelevant to the OCA stability proposal.[67] The OCA proposal does not hinge exclusively on the Postal Service committing to a short rate cycle. It is intended to provide greater convenience to the mailing public while permitting the Postal Service to meet the requests of large mailers for smaller, more frequent and predictable rate changes. But if conditions are such that rates need not be raised—low inflation, high postal productivity gains, volume growth, etc.—then the reserve account would not fall short if the rate stability plan were in effect. The plan works to the benefit of the public both in short rate cycles and when conditions permit the Postal Service to delay rate increases.

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66 *See, e.g.*, Tr. 22/10132-33 (Callow); Tr. 22/9829 (Rosenberg).

67 This appears to be an ongoing problem with the Postal Service. Senior officials make various statements to mailers that appear to differ from statements made for the benefit of the Commission. The OCA encourages the Postal Service to develop a more consistent approach to informing mailers, the Commission, and the public about the Postal Service's future rate plans.

The OCA notes that the Postal Service asks the Commission to "shelve" the plan and let it be considered by senior postal management. USPS Brief at VII-88. Naturally, the OCA hopes that senior management will give the plan serious consideration. The OCA suggests that the Commission actively encourage such consideration.

The Direct Marketing Association attacks the OCA's rate stability proposal as "unworkable and probably unlawful." DMA Brief at 9. Evidently, the DMA's concern is prompted by its belief that the proposal would primarily affect First-Class business mailers. *Id.* at 11. It is notable that none of the parties representing business mailers using First-Class Mail (such as the Major Mailers Association, the American Bankers Association, the National Association of Presort Mailers, and Keyspan Energy, Inc.) has taken this position.[68]

The reason, of course, is that the OCA proposal is designed to be limited to only single-piece First-Class Mail. This is the mail service used universally by households and by businesses for small volumes of First-Class Mail matter. The OCA proposal would set new rates for all workshare categories of First-Class Mail in every rate case based on a calculated First-Class rate. Only for single-piece First-Class Mail would the integer rate then be set to permit the rate to remain in effect through two rate periods. OCA Brief at 182-87.

The DMA is flat wrong when it states that OCA witness Callow acknowledged that the "vast majority" of mailers affected by the rate stability plan would be business

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[68] The DMA, as it stated in its intervention in this case, "expects to be concerned primarily with Standard (A) mail." "Notice of Intervention of Direct Marketing Association, Inc.," January 13, 2000.

mailers. DMA Brief at 11. The interrogatory response cited to by the DMA, appearing at Tr. 22/10181, concerned the OCA's primary proposal to retain the existing 33-cent rate. Witness Callow was asked to estimate the savings to all First-Class mailers if the rate remained at 33 cents rather than being increased to 34 cents, and what portion of those savings accrued to household versus business mailers. Witness Callow was *not* asked about the portion of single-piece First-Class Mail sent by consumers versus business mailers, as the DMA's brief suggests.

The DMA also complains that workshare incentives would be distorted. DMA Brief at 11. The OCA proposal, however, is careful to assure that workshare discounts are examined in every rate case, as is the calculated First-Class rate from which the workshare rates are set. The only effect is that the relationship between the integer rate for single-piece mail and the workshare rate for bulk First-Class Mail will change in the second rate case, because the integer rate will remain the same. Witness Callow calculated possible swings in workshare volume, and proposed a limit on the difference to assure that the swings are always moderate. OCA Brief at 185.

Nor does the DMA succeed in its attempt to cast a shadow on the OCA proposal by suggesting that it "entails significant legal problems." DMA Brief at 12. The OCA proposal works creatively within the framework of the Postal Reorganization Act. The prerogatives of the Postal Service with respect to the timing and size of rate requests and the timing of rate implementation are preserved. The rights of all parties to litigate any issue in every case are preserved. The use of the reserve account will assure that single-piece First-Class Mail breaks even over two rate cases, and that other classes of mail are unaffected by providing rate stability to single-piece First-Class Mail.[69]

VI. THE OCA COST MODEL IS ACCURATE AND RELIABLE

The Postal Service resists the use of any cost model other than its own. This includes resistance to certain improvements in the cost model process offered by OCA witness Thompson. Witness Thompson replicated the Postal Service's cost model presentation, then illustrated the effect of the recommendations of witnesses Smith and Ewen. Tr. 23/10407-415. In the course of doing so, witness Thompson corrected certain problems encountered with the Postal Service's cost model. Tr. 23/10410-412. The Postal Service did not challenge or rebut witness Thompson's testimony. On brief, however, the Postal Service now attempts to create the impression that the OCA cost model has "flaws" or that it is "difficult to use." USPS Initial Brief at V-159-60. To the contrary, the OCA cost model is an improvement in cost modeling that is accurate and that should be relied upon by the Commission.

The "flaws" claimed by the Postal Service are that witness Thompson had to manually edit certain data to remove Standard (A) single piece costs, that the OCA cost model uses a rounding program at the last stage before printing, and that the OCA simplified certain component numbering. *Id.* The rounding problem in the Postal Service cost model must be discussed to understand the need to manually edit the

[69] The Joint Brief of the Association for Postal Commerce and the Mail Advertising Services Association International discusses the stability proposal in a footnote. APC/MASA Brief at 8, n. 1. That discussion notes that if the Commission accepts the OCA's primary proposal to retain the existing 33-cent rate, it is not necessary to recommend the rate stability plan in this docket. The OCA agrees. OCA Brief at 187.

Standard (A) single piece costs. As will be seen, the Postal Service is clearly stretching to claim fault when there is none.

A. The OCA Approach to Rounding Is an Improvement to the Postal Service's Cost Model

The Postal Service's cost model is limited to storing integer values–whole numbers. Thus, whenever the USPS program performs a mathematical operation involving division or multiplication, the program has a problem, because it cannot store decimal values. Therefore, the USPS program must round each calculated result to an integer prior to data storage. While this may seem innocuous, it impacts the USPS roll-forward costs for each mail class and subclass. With each cost calculation, the potential to calculate a *real* occurs. Consequently, rounding takes place innumerable times as the USPS cost model costing and roll-forward process proceeds. A computer program that must repeatedly round costs to integer values prior to electronic storage is less accurate than one that maintains costs as *reals*.

To illustrate the effect of using integers (the USPS cost model) versus *reals* (the OCA cost model), consider the following example. Assume that in Year One, the actual material costs of manufacturing one widget are $1.00. Further, assume that producing a widget involves a manufacturing process that requires capital equipment, labor, a facility to house operations, etc. All production costs must be borne by the widget if production is to continue and the product is to break-even. For illustrative purposes, production costs increase widget manufacturing costs 60 percent. In our example, the final cost to produce one widget, in Year One, is $1.60 ($1.00 * 160%), if one uses the OCA cost model. However, if one uses the Postal Service's cost model program, the

$1.60 is subsequently rounded and stored as $2. Further assume that in Year Two, the cost to produce a widget is "rolled forward" so that the "forecasted" production cost can be determined. Continuing with our example, assume that in Year Two, production costs are expected to increase an additional 50 percent. In the OCA cost model, the widget in Year Two costs $2.40 ($1.60 *150%) to produce. However, using the Postal Service's cost model, the cost to produce one widget in Year Two is $3 ($2 * 150%). There are no differences in the costing assumptions. The entire difference is based upon how the data is stored electronically. The difference between the two cost models illustrates two points: (1) the Postal Service's model is less accurate than the OCA's, and (2) the Postal Service's model can artificially inflate costs.

The Postal Service fails to explain the multiple rounding methodology that is embedded in its cost model program. The OCA's cost model, however, rounds the data only once–just prior to printing. Even here, the use of rounding is only for convenience. The OCA model certainly is capable of printing *reals* to whatever degree of accuracy the user desires. However, as a practical matter, the OCA decided to round a *real* to "zero" decimal places based upon the number of columns of data to be printed on one page.

The OCA's rounding convention is not mysterious or hard to follow–it is basic third grade math. As explained by witness Thompson, any positive data value less than 0.5 is rounded down to 0.0; while 0.5 to less than 1.0 is rounded up to 1.0. Tr. 23/10436. Accuracy is improved by doing this only at the end, rather than at each computational stage throughout the cost model, as the Postal Service does.

In the postal rate making process, intervenors are concerned about "real" stamp prices. In many instances, the prices charged for postage are *reals*, not integers. Certainly, the Postal Service's cost model could stand improvement. Perhaps, the Postal Service should consider upgrading to the OCA's cost model.

B. <u>The Manual Editing for Standard (A) Single Piece Costs Is Clear</u>

As just discussed, the Postal Service's model is limited to storing integers. The Postal Service issued instructions to its computer model to split (*e.g.*, on a 95-5 percent basis) the costs for Standard (A) single piece letters between First-Class letters and Priority Mail prior to rolling forward costs to FY 2000. Subsequently, the results had to be rounded to the nearest integer, because the only instructions the USPS program could store were integer movements of costs between Standard (A) single piece letters to First-Class letters and Priority Mail.

The OCA's cost model replicated the Postal Service's commands exactly but did not force rounding at each step. Consequently, a few components had small fractions–*i.e. residuals*–remaining in the data file for Standard (A) single piece letter costs. The problem, therefore, stems from the Postal Service cost model. In a *few* components (not the "numerous cost components and segments" claimed by the Postal Service), the *residual* values rolled forward to the test year with printouts showing a negative zero or a one in the Standard (A) single piece letter cost category. In an attempt to minimize potential Postal Service confusion, OCA witness Thompson went back and issued instructions to the OCA cost model to automate the "zeroing-out" of the *few residuals*. This improvement was made to resolve the problem in the Postal Service model and to assist the Postal Service in following the change. It is hard to credit the Postal Service's claim that it found this "very difficult to follow." USPS Brief at V-159.

C. The OCA "Scratch Pad" Component Numbers Are Not Confusing

The USPS claims that the OCA cost model is confusing because it used the same ten component numbers for the same distribution keys spanning multiple roll-forward years. The Postal Service's cost model required twenty distinct component numbers to accomplish the same task. The OCA's cost model could easily have replicated the Postal Service's activity. However, in the interest of clarity, OCA witness Thompson chose simplicity over exact duplication. Once again, the Postal Service's complaint is pure makeweight.

It is apparent that the Postal Service is grasping for straws. The OCA replication of the Postal Service cost model was faithful, and the elimination of rounding until the final stage is an improvement that should be adopted by the Postal Service. The Commission should rely on the OCA cost model.

VII. NEITHER THE POSTAL SERVICE'S NOR CSA'S FEE FOR BULK PARCEL RETURN SERVICE SHOULD BE RECOMMENDED BY THE COMMISSION

The Postal Service proposes a fee for Bulk Parcel Return Service ("BPRS") of $1.65 per piece. It also recognizes that BPRS provides a fairly high value of service to both mailers and recipients. USPS-T-39 (revised 1/28/00) at 17. Nevertheless, it proposes a cost coverage of only 146 percent. In its initial brief, the OCA discussed why the Postal Service's proposed BPRS fee and cost coverage does not adequately reflect its high value of service. OCA Brief at 214-15. Moreover, the OCA discussed why the proposed fee should be rejected in favor of a Commission-recommended fee that results in a cost coverage at least as high as the proposed systemwide average in this proceeding. *Id.* at 215-18. Consequently, the following comments will address the mischaracterizations, factual errors, and twisted logic in the initial brief of the Continuity Shippers Association ("CSA") with respect to the appropriate fee and cost coverage for BPRS.

CSA claims that the cost coverage for BPRS is simply the outcome of "mathematical calculations," citing the testimony of the Postal Service's pricing witness Mohammad Adra (USPS-T-2) in Docket No. MC97-2—the proceeding in which BPRS was initially proposed. CSA Brief at 10. CSA makes this claim in support of its view that the Postal Service made "no statement" as to the "original intent of BPRS [ ] for a systemwide coverage." *Id.* This is also the corollary to CSA's view that "there was no agreement [among the parties] that the cost coverage should be at or around the systemwide average." *Id.* at 9.

CSA errs on both accounts and creatively interprets the history of this service. As Postal Service witness Adra made clear in Docket No. MC97-4, the proceeding that established BPRS:

> The proposed fees and fee levels were selected with the existing cost coverages and rate structures of related services in mind. At these fees, the cost coverage of BPRS is 156 percent. This cost coverage level is close to the systemwide cost coverage and easily recovers the associated cost (criterion 3). Docket No. MC97-4, USPS-T-2 at 16.

CSA's interpretation of history belies the facts. BPRS exists because the Commission approved the service at the request of the Postal Service with the agreement of the "parties" to a revised Stipulation and Agreement. *See* PRC Op.

MC97-4, Appendix A. Clearly, the "parties" cannot claim that they did not know that the BPRS cost coverage was approximately the systemwide average, and they certainly had ample opportunity to object. Moreover, the "parties" signatures on the revised Stipulation and Agreement, including that of CSA's, by definition constitutes agreement, if only tacitly, with the BPRS cost coverage proposed by the Postal Service at that time.

CSA also conjures up numerous other arguments in an effort to justify the alternative fee and the very low cost coverage it has proposed for BPRS. These arguments—that BPRS should have the same cost coverage as Standard (A) Regular, that the pricing criteria support a cost coverage for BPRS that is the same as Standard (A) Regular, and that a lower cost coverage for BPRS is justified—were dealt with extensively in OCA's initial brief.[70] However, CSA's creativity must be checked.

CSA makes the following claim: "[t]hat available alternatives are priced considerably higher *may* explain the demand for BPRS." CSA Brief at 14 (emphasis added). Not so. The existence of considerably higher priced alternatives *does* explain the demand for BPRS, Tr. 23/10712, which is relatively cheap (at the current fee of \$1.75) by comparison. *Id.* at 10723. And, contrary to CSA's view, demand, as measured by price elasticity, is a measure of value of service. OCA Brief at 216.

Moreover, CSA appears to make the convoluted argument that individual customer access to the Postal Service's collection system is somehow an inconvenience for the return of BPRS parcels and lowers the value of service. To wit:

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[70] *See* OCA Brief at 222-24; 215-18; and, 218-21, respectively.

> In addition, rather than just going to the mailbox, the original recipient may have to use a collection box of some other location rather than his own mailbox to enter the BPRS parcel. CSA Brief at 15.

First, CSA is incorrect. Under BPRS, the original customer is permitted to return a BPRS parcels using his own mailbox. Second, access to "a collection box or some other location" is an enhancement of service available to BPRS customers returning parcels compared to the conditions which existed prior to the establishment of BPRS. Before BPRS commenced, customers were obligated to visit a post office to weigh and pay for the return of their merchandise. OCA Brief at 218.

The only conclusion supported by the evidence in this proceeding is that BPRS has a high value of service. The Commission should reflect that high value of service by recommending a BPRS fee that produces a cost coverage at or above the systemwide average.

CONCLUSION

The OCA requests that the Commission issue its recommended decision consistent with the discussion of the issues presented in this Reply Brief and in the OCA's Initial Brief.

Respectfully submitted,

OFFICE OF THE CONSUMER ADVOCATE

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September 22, 2000

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document upon all participants of record in this proceeding in accordance with Section 12 of the Rules of Practice.

Stephanie S. Wallace

Stephanie S. Wallace

Washington, D.C. 20268-0001
September 22, 2000